



Quarterly Economic Update

October 11, 2017



MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

The Federal Open Market Committee (FOMC) met most recently on September 19-20th and left the target range for the federal funds rate unchanged at 1 – 1 ¼ percent, where it has remained following the last increase at the June meeting. The updated Summary of Economic Projections from the September meeting pointed to participants' views that one 25bp increase to the target range would likely be warranted prior to year end. Specifically, out of the 16 projections, only 4 thought it likely that the target range would be held at the current level through year end. The FOMC meets in November and again in December. With the December meeting being accompanied with a press conference and updated economic projections, it is viewed as the more likely meeting for another increase. The current implied probability of an increase sits at virtually 0% for the November meeting and 70% for the December meeting.

The September FOMC statement noted that inflation has declined and continues to run below the 2 percent objective. Lower inflation has been a lingering concern despite more constructive outlooks on economic growth and labor conditions that have led to tighter policy. Federal Reserve Chair Janet Yellen recognized the dislocation between inflationary readings and the committee's outlook in her post-meeting press conference. Brushing off concerns, she stated "We believe this year's shortfall in inflation primarily reflects developments that are largely unrelated to broader economic conditions . . . Such developments are not uncommon and, as long as inflation expectations remain reasonably well anchored, are not of great concern from a policy perspective because their effects fade away." The FOMC statement and Yellen also both acknowledged that while the recent hurricanes would have some near term effect on economic activity, labor, and inflation; they were unlikely to materially affect their medium and longer term outlooks and dictate any change to their policy stance.

The updated Summary of Economic Projections did not change significantly. The outlook for real GDP moved slightly higher for 2017 and unemployment is expected to run lower over the next few years. The inflation forecast moved lower again for 2017 and slightly lower for 2018, continuing the trend of downward revisions. In March, inflation projections for 2017 stood at 1.9%, falling to 1.7% at the June meeting and now 1.5%. Although these projections have been moving in the wrong direction, it should be noted that longer run projections are still expected to move toward their 2 percent objective.

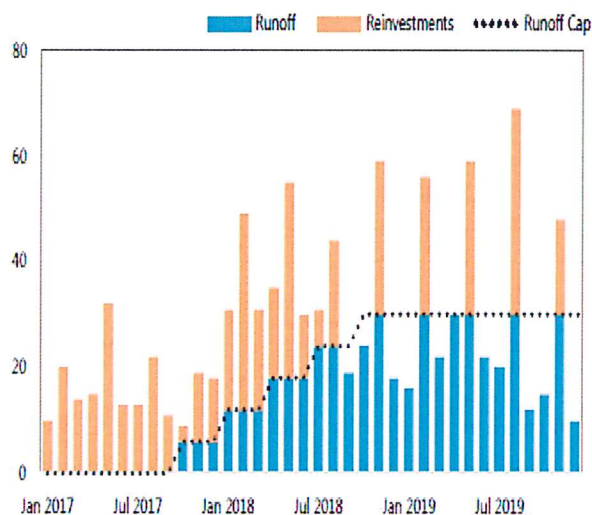
	2017	2018	2019	2020	Longer Run
Real GDP (Q4/Q4)					
September 2017	2.4	2.1	2.0	1.8	1.8
June 2017	2.2	2.1	1.9	n.a.	1.8
Unemployment Rate (Avg. 4Q)					
September 2017	4.3	4.1	4.1	4.2	4.6
June 2017	4.3	4.2	4.2	n.a.	4.6
Core PCE Inflation (% change)					
September 2017	1.5	1.9	2.0	2.0	-
June 2017	1.7	2.0	2.0	n.a.	-

Source: FOMC Summary of Economic Projections, Morgan Stanley

The FOMC did announce at the September meeting that they would begin implementing their balance sheet normalization process in October. The plan on how they would approach reducing the Treasury and agency securities held by the Federal Reserve was formally released at the June meeting. The July FOMC statement announced they would begin this process “relatively soon”, guiding market expectations toward the September announcement for implementation. The Federal Reserve’s balance sheet is currently around \$4.5 trillion and has been maintained at this level for several years by reinvesting maturities and principal payments from their securities holdings. The plan calls for the gradual reduction of reinvestment, leading the balance sheet to decline in an orderly and predictable manner. This will be done by setting caps on the monthly amount of principal payments received that will not be reinvested. They will only reinvest payment amounts once they have exceeded the monthly cap. These monthly caps will be gradually stepped up over time. For their Treasury holdings, the initial cap will be \$6 billion per month and will increase in steps of \$6 billion at three-month intervals over 12 months until it reaches \$30 billion per month. For agency debt and mortgage-backed securities holdings, the initial cap will be \$4 billion per month and will increase in steps of \$4 billion at three-month intervals over 12 months until it reaches \$20 billion per month. The charts below show how the monthly runoff caps will be implemented with the projected Treasury maturities and mortgage-backed securities principal payments.

Projected SOMA Treasury securities maturity profile

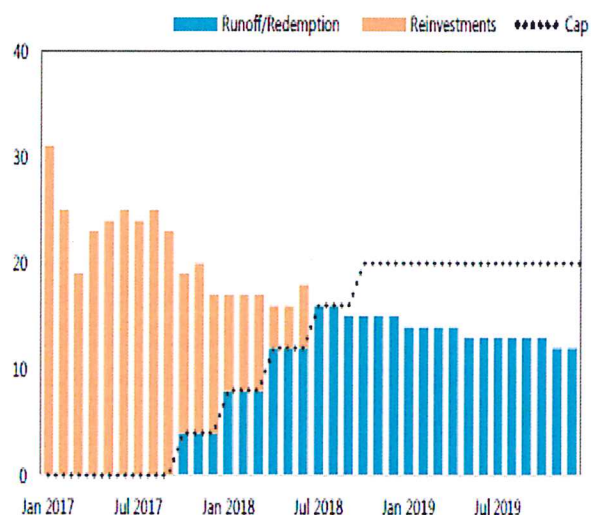
\$bn/month maturing, median scenario, Sep 2017 announcement



Source: FRBNY, Evercore ISI.

Projected SOMA MBS redemption profile

\$bn/month redeemed, median scenario, Sep 2017 announcement

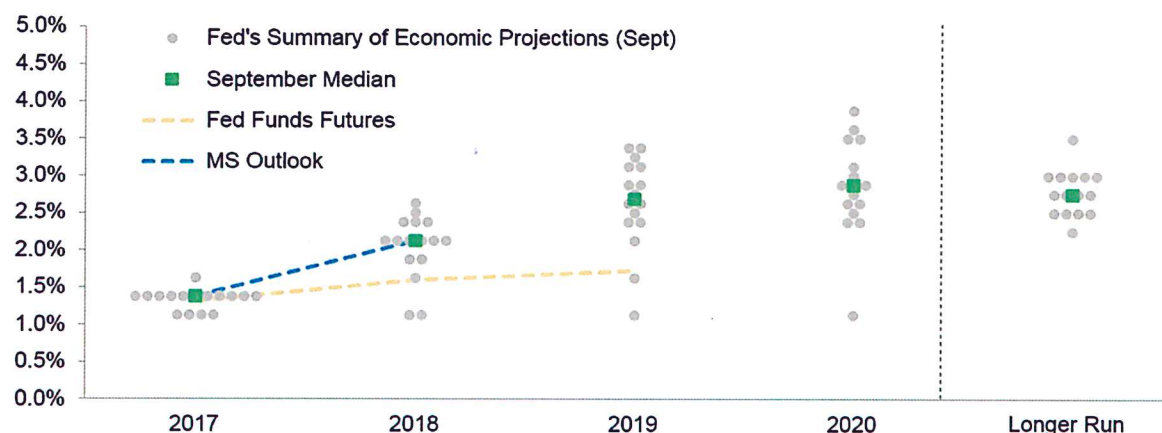


Source: FRBNY, Evercore ISI.

Overall, the projected path of the federal funds rate did not shift significantly from prior projections. FOMC participants expressed more agreement on 2017 with one more additional rate increase and three increases in 2018. The 2019 median did shift down by 25bps, as well as the longer run estimate. The chart on the following page shows the updated “dot plot” with the FOMC participants’ projections and the median path

highlighted by the green dots. Market expectations expressed with fed funds futures continue to reflect a lower path for the federal funds rate.

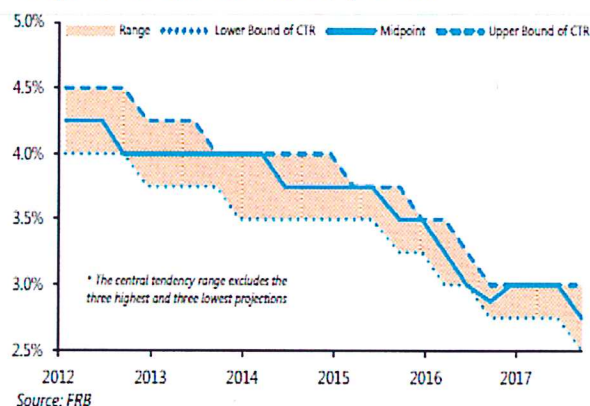
September FOMC Dot Plot



Source: FOMC Summary of Economic Projections, Morgan Stanley

More notable is the downward shift in the longer run estimate. As shown in the chart on the right, the longer run estimate has been trending lower over the past several years. This likely reflects expectations of a lower neutral rate going forward and lower inflation. Without the threat of stronger inflation, this longer run estimate may continue to come down. In addition, the FOMC is not likely to push rates above their view of the nominal neutral rate without stronger inflation.

Evolution of central tendency* range of Fed SEP longer-run fed funds rate estimate, by SEP date



Yellen and the FOMC have been pretty transparent on the direction of policy and have sought to guide market expectations through their various forms of communication. Policy action is ultimately dictated by economic conditions, but this has been a very transparent FOMC. It should be noted that while no changes in this approach are expected, the makeup of the Federal Reserve Board and the FOMC is undergoing significant turnover that may be led by a new Federal Reserve Chair in the near future. Out of the seven seats on the Federal Reserve Board, four are now vacant with the recent resignation of Vice Chairman Stanley Fischer. Yellen's term as Federal Reserve Chair expires in February 2018. President Trump has not ruled out a Yellen reappointment, but is publically considering others for the position. If Yellen is not reappointed, it is unlikely she would continue to serve out her remaining term on the board. That would leave five of the seven positions on the Board of Governors open for new appointments, including the Chair and Vice-Chair positions. This leaves open the potential for change in the direction and approach of policy decisions going forward. President Trump has indicated he will make a decision around the Federal Reserve Chair position soon and various names being considered have been thrown around, but at this point it seems somewhat futile to try to speculate who may ultimately be appointed to fill these slots.

Fiscal Policy

By Michael McNair

After the election, President Trump and the Republican leadership laid out their legislative agenda which consists of three main legislative goals: 1) healthcare (specifically repealing Obamacare 2) infrastructure stimulus and 3) tax reform.¹

In the months after the election, the market and political prognosticators were highly confident that Trump's agenda would fully and swiftly be pushed through Congress. This confidence was not unfounded, as the Republicans held the White House and a majority in both houses of Congress. However, despite a unified government in Washington, here in the *Fiscal Policy Report* we were skeptical, to say the least. Since the election, our base case forecast has been that the Republicans would fail to push through even a single one of the three items on their policy agenda. Since our non-consensus call, the GOP has now accepted defeat on repealing Obamacare, after three failed attempts, and they have abandoned any hope of pushing through an infrastructure bill before the midterm elections.

Our ability to properly forecast this turn of events is a result of our process of focusing on constraints. Therefore, in this edition of the *Fiscal Policy Report*, we will take a deeper look at the set of constraints facing the President and GOP leadership, explain how it has thus far thwarted their legislative agenda, and examine how it is likely to impact the coming tax reform legislation.

Imperatives and Constraints

It is our belief that the best model for forecasting geopolitics is by examining the actors' imperatives and constraints. Imperatives are the things that must be accomplished in order for a community (or in this case a political faction) to survive and prosper, while constraints are the things they are prevented from doing. When any President is voted into office their imperatives are usually made clear. In the case of President Trump, his legislative agenda was laid out within days of his inauguration and it focuses on three main goals: 1) healthcare (specifically repealing Obamacare 2) infrastructure stimulus and 3) tax reform.

However, what is less understood is that the President will always be confronted with a set of constraints that limits his ability to achieve his imperatives. In the case of President Trump, we initially identified two main constraints. The first was that due to Donald Trump's divisiveness no Democrats would be willing to work with the President to make bipartisan deals. This constraint facing his presidency is largely the result of a decision he made to deal with a constraint he faced as a candidate. Facing long odds, Donald Trump needed to develop a platform that would allow him to win the election. His solution was to resort to populist politics and other tactics that are less than respected by much of the establishment; yet,

¹ We should emphasize that we are only talking about President Trump's legislative goals. He certainly has more goals, such as reducing the United States' trade deficit, but he is pursuing these goals outside of the legislative process and these goals are outside the scope of fiscal policy.

were wildly effective in securing him the presidency. However, there is a difference in running for office and governing and the actions that were so beneficial for candidate Trump have proven detrimental to President Trump. The Democrats refusal to work with President Trump has forced the GOP to push through his legislation with a slim Republican majority.

President Trump and the GOP leadership's second constraint is that deep factions exist within the Republican Party whose own imperatives are in direct conflict with each item on the President's legislative agenda. Add in the fact that a slim majority gives every Republican Congressman significant leverage and you have a recipe for failure.

Since the election, another constraint has developed that is now stifling the GOP agenda: President Trump's low approval ratings. George Friedman, founder of Stratfor and Geopolitical Futures explains, "Trump's approval ratings are in the high 30s. Many of his supporters deny that this is true, but what matters is only whether the Republicans in Congress believe it. They do, and that is Trump's biggest political problem. The rule of thumb is that the country is roughly divided 40-40-20 between Republicans, Democrats and independents. When a president's rating is 40 percent or lower, it means that his support is down to his political base. To be re-elected, he must boost his ratings to at least 50 percent regionally distributed, and that means he can't follow policies that please only his base. And in order to govern, he must have his own party in Congress united behind him. That isn't going to happen with approval numbers in the 30s."

There are times when a politicians self-interests are opposed to their party's legislation and they must decide if they should make a sacrifice for the party. If the President is wildly popular then having his support is crucial to winning reelection and party members will fall in line and support the President's agenda. However, many Republicans are concluding that they will not support legislation opposed by their base when the President's approval ratings are in the 30s.

In just over a year all members of the House and a third of the Senate will be up for reelection and they are assessing the value of being close to the President. In that regard, the special Senate election in Alabama is a horrible sign for the President and the GOP leadership. Roy Moore was able to defeat Luther Strange despite President Trump personally campaigning for Strange. If Trump's support did almost nothing to improve a candidate's numbers in the state where Trump is most popular, then what does this say to Republican's from more moderate districts? And importantly, what leverage does President Trump have to coerce a Republican Congressman to support legislation which they fundamentally oppose? To summarize, President Trump and the GOP leadership are constrained by the fact that they must rely exclusively on Republican votes to pass legislation through Congress when they only have a slim majority (they can only lose 2 Republican votes in the Senate and 20 in the House). Therefore, they must have near unanimous support within the party, at a time when the party is at one of its most divisive points in its history, and the President's poll numbers are too low to ensure that party members fall in line with the President's agenda.

Understanding the GOP's constraints allowed us to ascertain a simple conclusion. The President could not pass legislation that impaired the fiscal position of the government because the Freedom Caucus refuses to compromise on issues of fiscal responsibility and they have more than enough votes to block any legislation; yet, all three of the Presidents' legislative goals expand the budget deficit.

We can examine in detail how these constraints have thus far worked to thwart the President's agenda.

Healthcare/Obamacare Fix

First on the GOP legislative agenda was a fix for Obamacare. It was supposed to be easy to pass healthcare legislation because Obamacare is universally loathed by Republicans. However, Republicans failed to agree on how to address the issue.

The Obamacare legislation is fundamentally flawed and serious modifications are needed to prevent its failure but President Obama knew this from the start. The Obamacare bill is not the legislation that President Obama preferred but an amalgamation of compromises that were necessary to pass a bill which expanded coverage for 30 million Americans. President Obama was willing to pass a bill which created a system that he knew was unsustainable because he understood that once millions of Americans are given coverage it would be politically impossible to take that away from them in the future.

The merits of knowingly passing a defective Obamacare Bill can be debated, but what is certain is that it has constrained policy-makers options in fixing Obamacare. The Republican leadership never seriously considered legislation that would have taken away anyone's health insurance (despite what you may have heard from certain sources). Instead, GOP leaders were forced to settle on a plan to repeal and replace Obamacare. However, the members of the Freedom Caucus were fundamentally opposed to any legislation which "replaces one entitlement program with another". They believe the voters gave them a specific mandate to reduce the budget deficit and federal debt and they have refused to settle for anything less than the complete removal of Obamacare. Their ideological opposition was so strong that they chose to keep Obamacare rather than voting for the GOP legislation which repealed and replaced Obamacare. Because the Republicans could only afford to lose two Senators or 20 House members, the Freedom Caucus had more than enough votes to block their own party's legislation.

Infrastructure Stimulus

Soon after the election Trump and his team began touting his plan to increase infrastructure spending by \$1 trillion. The market was quick to respond in pricing in an infrastructure stimulus but we were skeptical. The problem as we saw it, was that infrastructure spending must be deficit-financed, and not offset with taxes, in order stimulate the economy. However, the Freedom Caucus will never support a budget-busting infrastructure spending bill.

In the November 2016 edition of the Fiscal Policy Report, we stated, "Many investors are betting that infrastructure spending is likely to surge over the next couple of years. We have consistently heard numbers like \$550 billion or even \$1 trillion in infrastructure spending. However, we believe that the market is getting ahead of itself...the Tea Party still has a strong position among Republicans in Congress and they are unlikely to give President-Elect Trump a blank check to increase the deficit...therefore, we place low odds on a large infrastructure spending bill."

The market eventually came to realize that there will be no infrastructure stimulus for the foreseeable future and even President Trump has abandoned hope of passing legislation in this Congress. Ironically, the best chance for President Trump to push through infrastructure legislation is in the event that the Democrat's take control of Congress after the midterm elections and are willing to work with President Trump. We will not completely rule out this possibility because infrastructure spending is an important issue to many Democrats backed by labor unions that would benefit from such legislation. However, we believe that the most likely outcome is that the midterms turn into a referendum on President Trump and Democratic Congressmen and women will be given a clear mandate by their constituents not to work with Trump under any circumstance. The Democrats that win their election will likely have done so on an anti-trump platform; therefore, we place low odds that those Democrats will turn around and give President Trump a much-needed legislative victory. Even if Democrats do decide to support an infrastructure bill, the stimulus will not impact the economy until at least 2019.

Tax Reform

Tax reform is the next item on the GOP agenda but the same set of constraints that have derailed their previous legislation will prevent meaningful tax reform.

The first problem is that without bipartisan support the Republicans do not have the 60 votes needed to pass a tax reform bill under normal Senate rules; therefore, Republicans must use the reconciliation process which only requires a simple majority to pass. The downside of using this process is that any reconciliation bill cannot increase the deficit outside of the budgetary window. This is why the 2001 Bush Tax cuts expired after 10 years. Further, the House reconciliation instruction requires "revenue neutrality" which means that for every dollar cut in taxes, an equivalent amount needs to be removed in deductions and credits.

For every 1% reduction in the corporate tax rate, policymakers need to find \$100 billion of revenue over a 10 year period. President Trump's plan is to cut the corporate tax rate from 35% to 20%, which means Congress will need to find \$1.5 trillion of tax revenue from another source just for this part of his plan.

Revenue neutral tax reform is a zero-sum game. Which means that policymakers are picking winners and losers. If someone's effective tax rate is going down then someone else's is going up.

Most of the tax offsets will need to come from eliminating tax deductions and credits which will face stiff political opposition because there are powerful special interests that benefit disproportionately from these provisions. They might see their corporate tax rate cut but they will be worse off as their effective tax rate will rise with the loss of these credits and deductions. Therefore, it is a certainty that these “losers” will lobby strongly against tax reform.

Earlier we stated that the Republicans could only afford to lose two GOP Senate votes to pass legislation. However, with tax reform, they can only afford to lose one vote because Sen. McCain is a definite no vote on tax reform (as he was on the Bush tax cuts). The important point is that it will be remarkably easy for the “losers” in corporate tax reform to successfully kill this legislation because they only need to convince two Senators that it is against their interest to support this bill.

Only once in 100 years has the US successfully passed revenue-neutral tax reform and even then it was after Ronald Reagan won 49 states in his reelection. If tax reform is difficult even in the best scenario, then we believe it is nearly impossible under the current set of constraints.

Regardless of whether the GOP leadership is willing to admit it, true, permanent tax reform is off the table but the GOP does have another option. They can attempt to pass a temporary tax bill which increases the deficit. In this way, they can cut the effective tax rate for corporations and individuals without having to fully offset the lost tax revenue. Which means there will be more winners than losers and, theoretically, less opposition from corporate special interests.

However, there are a few problems with this plan. First, in order to pass a tax bill that increases the deficit, the Senate Budget Committee has to pass legislation to rewrite the reconciliation instruction. Yet, in order to change the instruction they need to convince the Freedom Caucus to agree to allow the deficit to increase. The Freedom Caucus has already killed the GOP healthcare and infrastructure legislation because of their staunch opposition to increasing the budget deficit and they will not support a budget-busting tax bill. However, there are a couple of loopholes that the GOP leadership will attempt to use to compromise with the Freedom Caucus deficit hawks. Dan Clifton, Senior Policy analyst at Strategas Research, explains, *“Initially, the plan in the Senate was to keep the revenue neutral instruction, but make two very important changes allowing for greater flexibility: First, allow for dynamic scoring which says that as tax rates are lowered, nominal GDP will expand, and this produces a “feedback” effect on tax revenues. Based on previous dynamic scores of tax reform legislation, policymakers were hoping this change would reduce needed tax revenues by \$500bn. The second change would move to a current policy baseline which in simple terms would assume that any temporary tax cut currently in law today would be assumed to be permanent over the next 10 years. This would lower the baseline by an additional \$500bn.”* The net result of these two deals would be to allow Congress to cut taxes by \$1 trillion over 10 years without having to “technically” increase the deficit.

However, the Senate Republicans shifted their strategy in recent weeks because the Parliamentarian has refused to accept the Republican’s request to use dynamic scoring and the current policy baseline as part of the reconciliation test.

Now the GOP strategy is to rewrite the reconciliation rules to allow for a \$1.5 trillion deficit increase over 10 years. The argument is that even though the Senate Parliamentarian is not recognizing the impact of dynamic scoring (specifically the argument that these tax cuts create economic growth which has a feedback loop of lowering the government budget deficit) the members of the Freedom Caucus can still sell that narrative to their constituents and claim they aren't really increasing the deficit.

There are two problems with this strategy. The first is that a reconciliation bill cannot increase the deficit outside the budgetary window. Therefore, the laws in this tax bill will only be temporary and the entire purpose of tax reform is to make it permanent. The second problem with this strategy is that the headline from the Congressional Budget Office (CBO) will still say that this bill increases the deficit by \$1.5 trillion. Voting on this bill will occur just months before the midterm election and it is a given that this headline will be valuable ammunition for challengers to use against the incumbents if they vote for this bill. Perception is all that matters in politics and we do not believe that Republican Congressmen and women will believe they can convince voters that "due to dynamic scoring and economic feedback loops they really didn't vote to increase the deficit". If repealing and replacing Obamacare wasn't enough to persuade the Freedom Caucus to bend on fiscal responsibility, we find it hard to believe that will vote for a bill which explicitly increases the budget by \$1.5 trillion dollars to provide a temporary tax cut. For this reason, we do not believe that the Republicans can pass a large deficit-financed tax bill.

The Republicans constraints put them in an impossible predicament in regards to tax reform. The less they increase the deficit, the less push back they will get from the Freedom Caucus but the more "losers" they will create who will strongly oppose the legislation. The more they increase the deficit the more the Freedom Caucus will oppose the legislation but the fewer "losers" they will create with the incentive to lobby against the bill. Navigating these constraints would be a tall task even if the Republicans had a wide margin of error and a wildly popular President, but considering the Republicans can only afford to lose a single vote, in a party deeply divided, and with a President whose approval ratings are in the 30s, we believe this will prove too much for the GOP leadership to overcome. Thus, we place low odds on meaningful and stimulative tax reform.

Economic Outlook

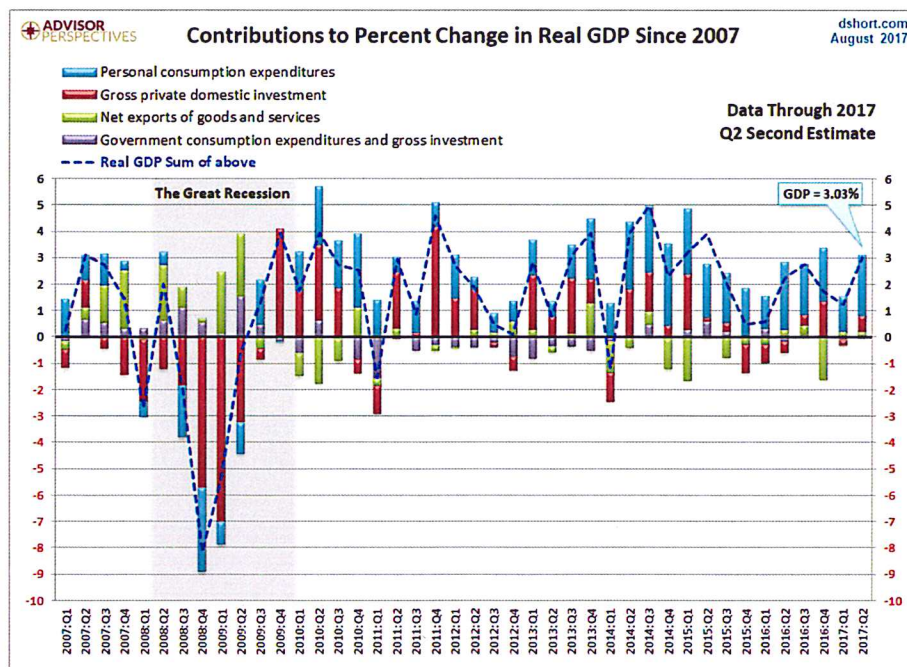
By Adam Rogers

Over the next few months, and including the latter part of September, economic activity and data will be affected by storm related disruptions and rebuilding efforts. A press release by the Federal Reserve on September 20th makes a point that “past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term.” This “course of the national economy” continues to look strong in our judgment. Growth is ticking up, jobs are plentiful, and inflation remains in check. Absent the storms, there have not been many major adjustments to the US backdrop.

Growth

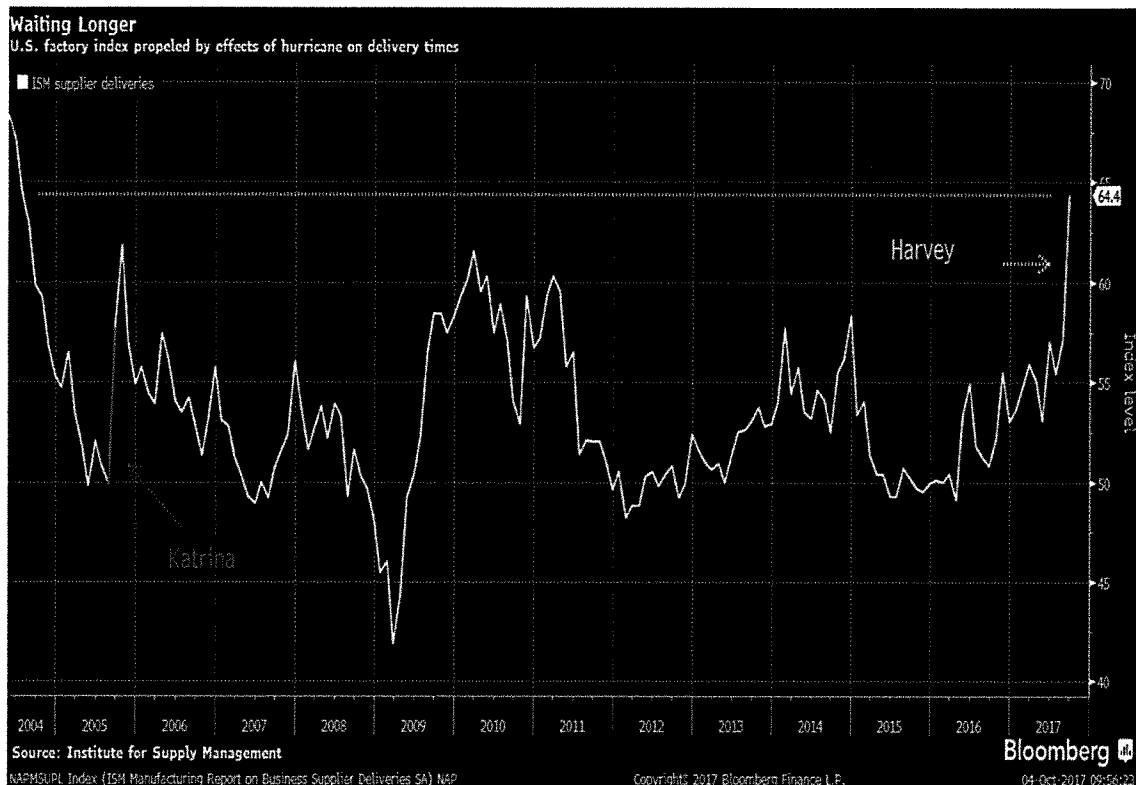
The final estimate of real GDP growth in 2Q was revised above consensus expectations, as the initial print of 2.6% was raised to 3.1%. Composition continues to be heavily reliant on consumer spending, which remains strong due to a robust job market, contained inflation, and low borrowing costs. Business investment also contributed, getting a boost from software, structures, and equipment, suggesting companies are growing more optimistic. Consensus is building that we are setting up for further acceleration in the second half of the year, though this is the last clean look we will get before data is distorted by the recent hurricanes. Fallout from the storms will likely trim 3Q growth, though rebuilding efforts will create a boost we should see in 4Q and beyond. The following chart is a breakdown of contributing factors to the 3.1% 2Q growth estimate.

Figure 1: US Real GDP Growth



One of the more drastic hurricane-related effects has been revealed in the ISM survey, which surged to a 13 year high in September. The headline print of 60.8 exceeded expectations and is the strongest we've seen since May 2004, giving a compelling signal of accelerating economic activity. The storm effects centered on slower delivery times, which are usually interpreted as rising capacity use in factories and are therefore viewed positively. In this case, the supplier deliveries sub-index shot up 7.3 points to 64.4.

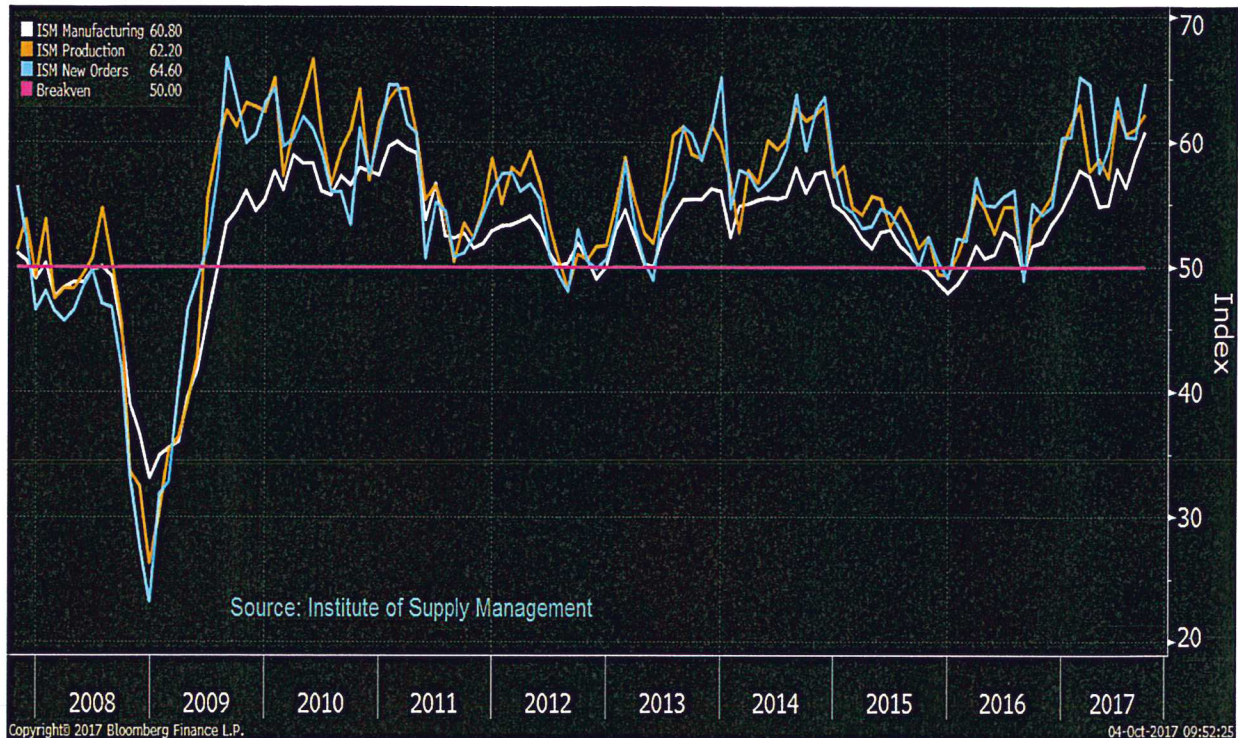
Figure 2: ISM Supplier Deliveries



Gulf hurricanes which hit major hubs such as Houston, or the mouth of the Mississippi as Katrina did, tend to have a drastic impact on supply chains. The strength in September shouldn't be dismissed, though, as the upside was not entirely attributable to supply chain disruptions. New orders rose to 64.6 from 60.3 prior, and production advanced to 62.2 vs 61. So while the headline would not have spiked as it did absent the storms, it would have still shown strength. The non-manufacturing PMI also increased to 59.8, the highest since 2005.

Historically, an ISM in the high 50s and low 60s is accompanied by GDP growth of at least 3%. So from an outlook perspective, while 3Q may be depressed, it should not be difficult for the economy to register 3% growth in 4Q, all else being equal. The rebuilding efforts and the boost they provide to GDP will be the prevailing theme over the next few months.

Figure 3: ISM Manufacturing



Consumer

While contributions from business spending are encouraging, the consumer remains the workhorse for the economy. New highs in home and stock prices are creating a supportive wealth effect, despite a falling savings rate. The data for this quarter again is being disrupted by the storms, with August results being held back by fewer outlays for vehicles, and recent indications of a big uptick in purchases to replace vehicles lost. We'll have to wait until these replacements run their course to get a feel for the overall trend.

The mix of spending trends is certainly shifting, with traditional ways of shopping under increasing pressure. However spending remains resilient as consumers buy online rather than at stores, spend more on experiences rather than goods, and use technology to comparison shop. We expect real US consumer spending to continue to trend around 3%.

Wage growth is still tepid, despite an economy at full or at least close to full employment. The Employment Cost Index shows US compensation is still restrained. Labor should be taking a greater share at this point in the cycle, but this is only happening very slowly.

Figure 4: Consumer Spending

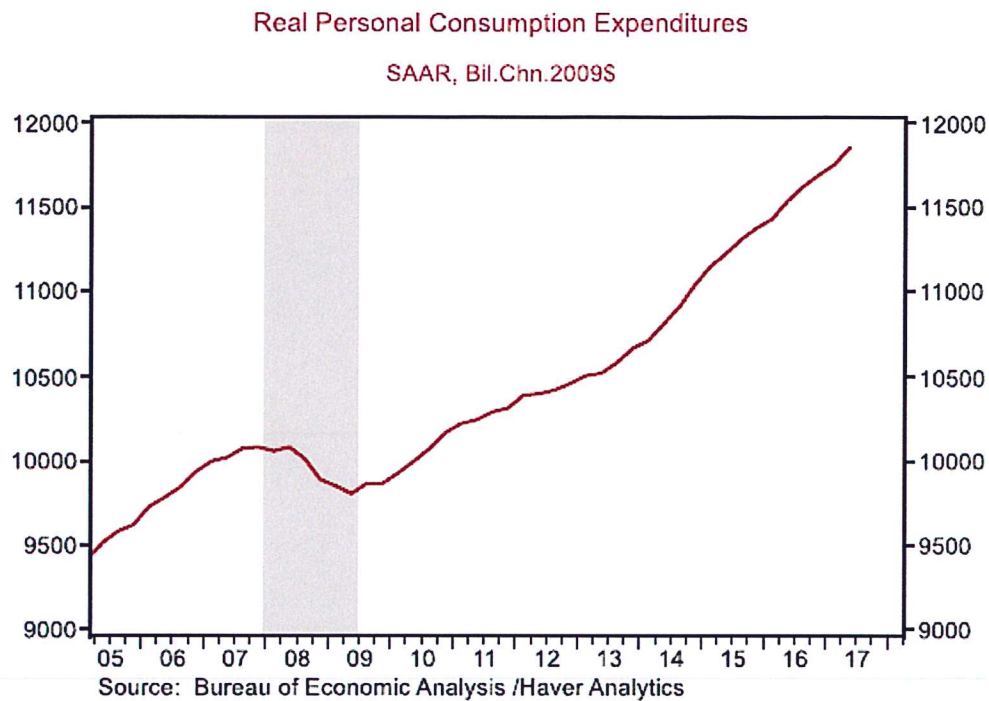
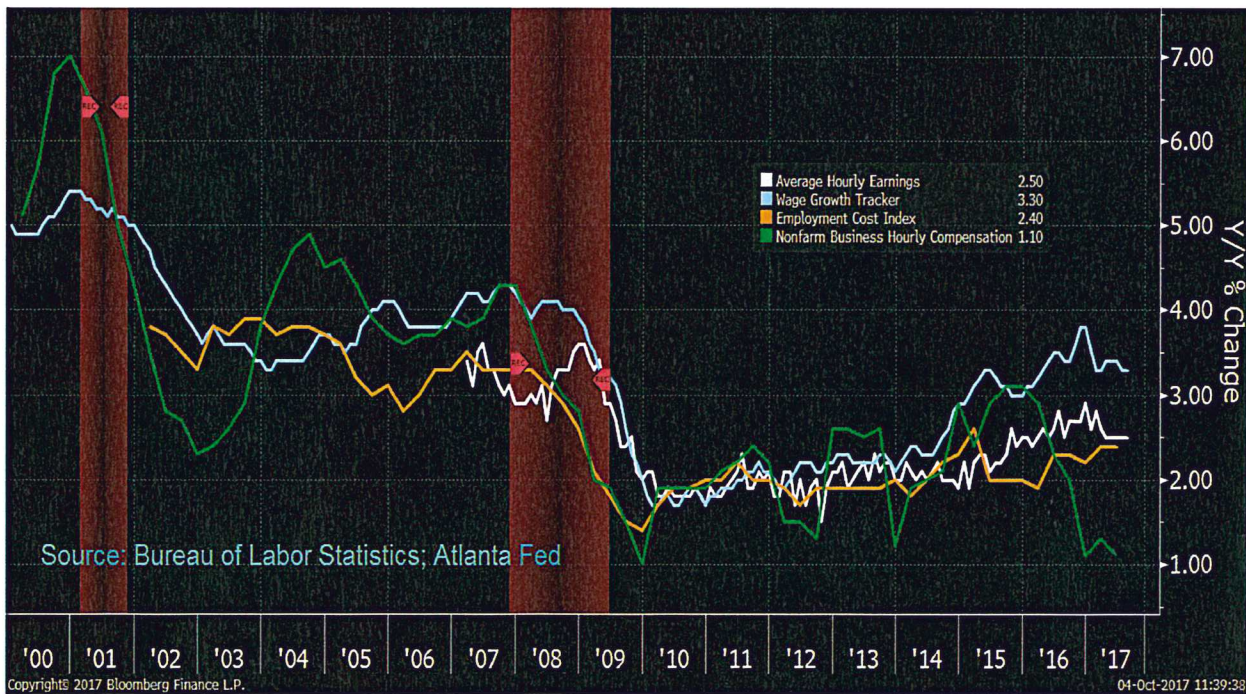


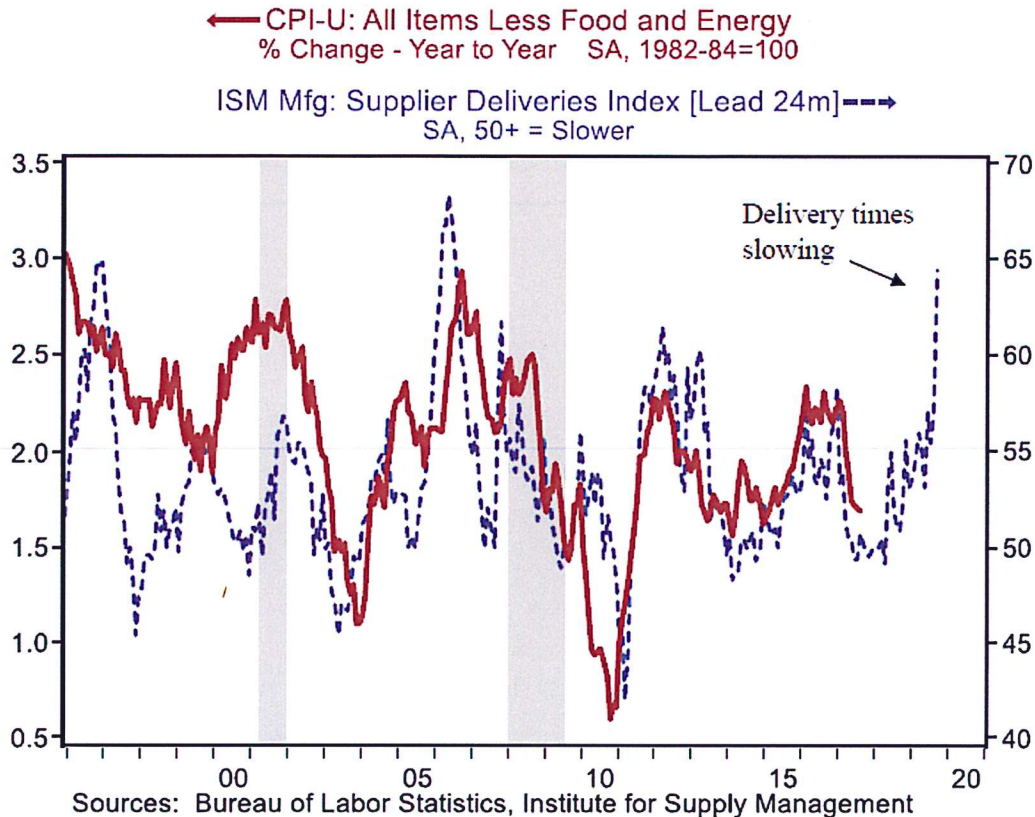
Figure 5: Wages



Inflation

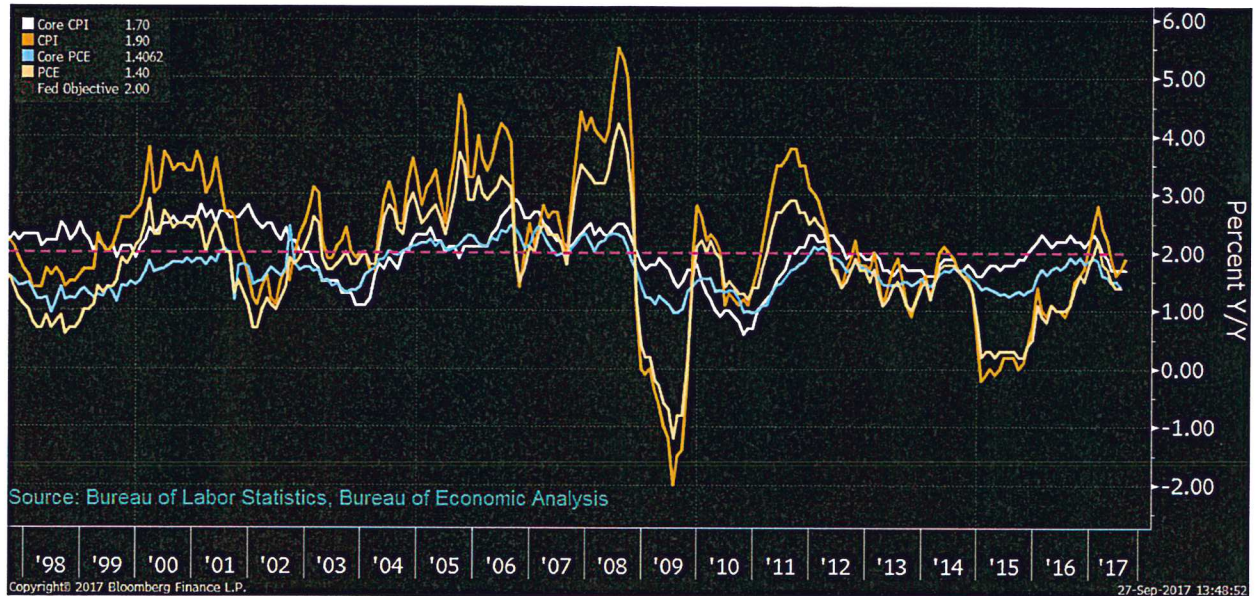
Here again, we have to be careful with weather related effects. The spike in delivery times mentioned earlier is usually a reliable leading indicator of inflation, and the August inflation data showed some signs of price pressures in certain sectors, as both gas prices and hotel rates surged following the storms.

Figure 6: Delivery Times and Inflation



These distortions will create a challenge for the Fed. If the inflation data accelerates over the next few months, it may only be the transitory supply chain disruption. There is a risk that policy makers will conclude that the inflation is indeed systemic and proceed to combat it at a pace faster than they would have absent the storms. We would gamble this is a minor risk, and the Fed will have the foresight to filter the next few reports on inflation and not blindly react to the headline data.

Figure 7: Inflation Measures



To summarize, not much has changed directionally over the past few quarters. Growth is still positive and slightly accelerating, the consumer looks healthy, and unemployment is low. Wages are growing but at a pace slower than expected at this point in the cycle, and inflation is not problematic. We will continue to monitor the effects of Harvey and Irma which will play out over the next few months.

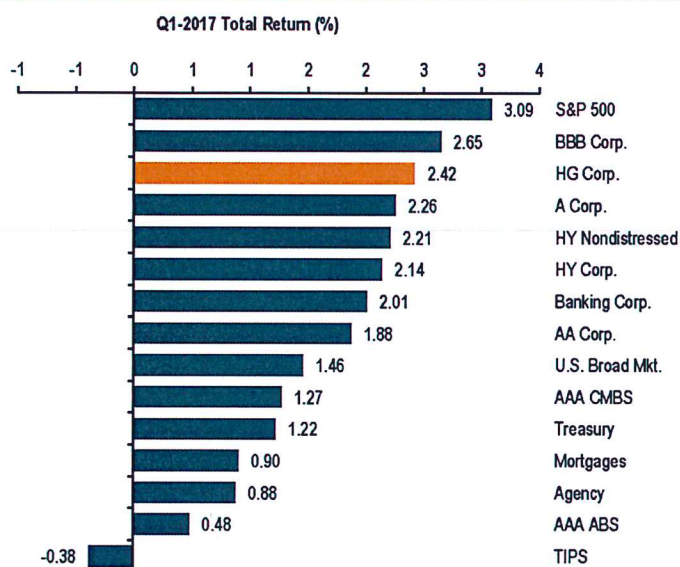
RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Julie Barranco

At the time of our last meeting the June quarter was coming to an end. The Fed had met and increased the federal funds rate by another .25% to 1 – 1.25%. The increase was widely expected and accepted by the markets. The Committee also briefly discussed the intention to begin reducing the securities holdings on the Fed's balance sheet later in the year, a move that also was widely expected. The quarter ended on a positive note with risk assets including equities and credit performing the best. Returns across the different asset classes for the third fiscal quarter are shown below.

Figure 6: Broad Asset Class Total Return Performance, Q2-2017



Source: BofA Merrill Lynch Global Research

July began with rates moving higher. The release of the FOMC minutes and its somewhat hawkish tone, coupled with the strong economic data releases early in the month were the main drivers of this move. Credit remained firm during this time period as we also saw a strong start to the corporate earnings season; supply early in the month was almost non-existent due to the July 4th holiday.

Later in July sentiment changed a bit as Janet Yellen completed her semi-annual testimony to Congress. With her commentary having a more dovish tilt to it than expected, and with soft economic data releases that same week, Treasury yields reversed course and moved lower. While the Fed's plan for balance sheet normalization still seemed to be on track for the fall, the probability for a rate hike fell and December became the earliest point at which the market expected an increase. Credit spreads remained firm as equity markets responded positively to the likely postponement of the next rate hike. High grade and high yield spreads moved tighter with high yield outperforming for the first time in several weeks. The month ended with Treasury yields little changed, credit spreads tighter and risk outperforming.

August began with mixed economic data. While the July employment number came in stronger than expected, other data was a bit softer. Additionally, the wage growth trend still seemed to be stuck in a rut; low wage growth has been noted by the Fed and is likely a piece of the low inflation puzzle. As the PPI and CPI data both came in on the soft side, Treasuries rallied across the curve and the probability of a Fed rate hike by year end fell again. The benign inflation picture and geopolitical tensions led to many investors believing that the Fed was putting a rate hike on the back burner for now. The minutes from the July Fed meeting, released mid-August, seemed to confirm this as the members noted that risks to the inflation outlook “continued to be tilted to the downside.” The minutes also indicated that the normalization of the balance sheet would still be set to start before the end of the year, possibly as soon as September.

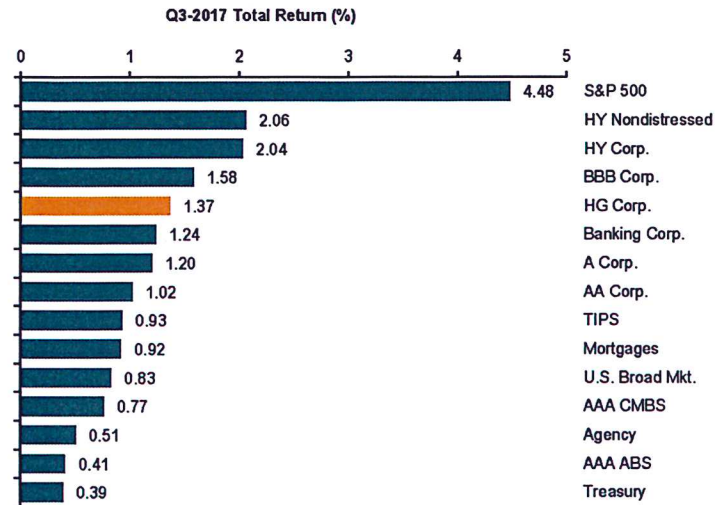
Mid-month Treasuries caught a safe haven bid as the equity markets stumbled in response to more negative political news as the prospects for fiscal reform dimmed. After another notable departure from the President’s administration, the markets recovered somewhat. The corporate bond market remained resilient and new issue activity was solid. A couple of larger deals, including Amazon’s \$16 billion multi-tranche deal led the activity. For the month, higher quality sectors outperformed lower quality; Treasuries returned 1.13% while high grade corporates returned .85%. High yield performed the worst at (.03) % for the month.

September started on a weak note as well as two back to back destructive hurricanes, Harvey and Irma, hit the U.S. and inflicted their damage. This, along with continued flare ups from North Korea and worries about the debt ceiling discussions and vote were all contributing factors. The risk off mood continued and Treasury yields rallied to their lows of the year. The ten year Treasury yield touched 2.01% while the five year yield touched 1.61%. This mood did not last long however. Although still a catastrophic storm, the damage from Irma was not quite as severe as expected. Additionally, Congress voted to suspend the debt ceiling decision until December and approved disaster relief funds to help with the storm recovery. These events led to a large relief rally in equities the following week.

On September 20th the Fed met and as expected, they voted not to raise rates. Also as expected, the Fed confirmed their plan to start the reduction of their balance sheet in October by reducing purchases of Treasury and mortgage securities by \$10 billion per month initially and then increasing these amounts gradually. This program is not expected to cause much if any disruption to the markets as there will still be demand for government securities. What was a little surprising to most was the fact that the Fed’s dot plot, showing future rate expectations, stayed the same indicating one more rate increase this year and 3 increases for 2018. The members also acknowledged the inflation rate was still below levels where they thought it should be and would likely stay low for the time being. Interest rates reacted accordingly after the meeting with shorter end yields rising more so than longer end yields, leading to a flatter curve. Subsequent speeches by Fed members in the days after the meeting seemed to confirm their belief that rates needed to rise further, with Janet Yellen stating that “it would be imprudent to keep monetary policy on hold until inflation is back to 2%”. Fed Fund futures currently predict roughly a 70% chance of a rate increase in December. Presuming no one-off incidents or shocks occur, we believe this increase will happen.

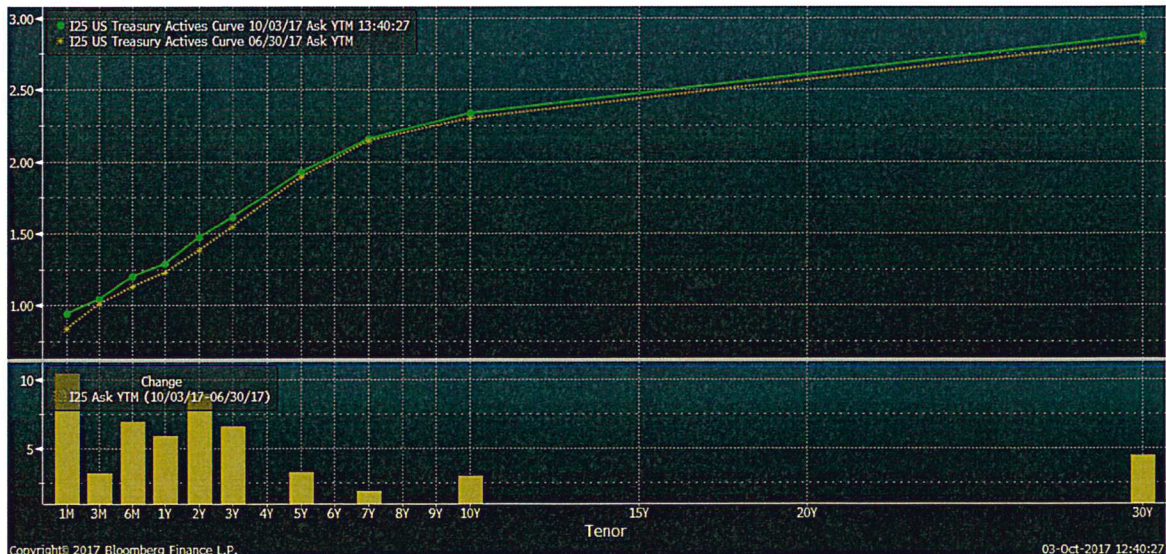
September was yet another good month for risk assets, with equities performing the best. Within the bond market high yield performed the best with nearly a 1% return for the month. High grade saw spread tightening as well, although not to the same degree. Government securities, the safest sectors, returned the least for the month. Returns for the fiscal fourth quarter are shown below:

Figure 6: Broad Asset Class Total Return Performance, Q3-2017



Source: BofA Merrill Lynch Global Research

Despite some rate volatility throughout the summer from fiscal and monetary concerns as well as hurricanes and geo-political events, Treasury yield levels ended the quarter very close to where they started.



Source: Bloomberg

While the front end of the curve is several basis points higher due to the actual and expected rate hikes, the intermediate and longer end of the curve are essentially at the same levels. Because inflation expectations have remained low there has not been a reason for long end yields to significantly rise. With the ECB having tapering discussions and the BOE considering a rate hike, thoughts about inflation cannot be ignored, but it is still not a threat at this time.

Despite the overall low volatility in yields that we have experienced through the summer, we have been somewhat active within the fixed income portfolio. Activity in the corporate sector has been concentrated more in the secondary market than the new issue market. At different points over the past couple of months we added some shorter maturity issues, such as Dominion Resources, BP Capital and AT&T. In these cases we were able to lock in very attractive spreads over comparable Treasuries yet not take on much interest rate risk in the process. Given the overall tightness of spreads within the credit sector for the past several months and considering our overweight within the sector, we felt this was a prudent way to invest at attractive yields but not really raise the risk profile of the portfolio. Within the new issue market, we participated in Amazon's 7-year issue as it was offered at an attractive spread and was expected to perform well. We will continue to look for attractive names/maturities to selectively add to the credit sector, particularly if we get any kind of weakness in spreads that provides an attractive opportunity.

In the agency debt sector we have seen spreads remain stable and fairly tight. Over the past couple of months we have replaced two maturities, purchasing a 3-year agency issue and a 5-year agency issue. We also participated in a swap selling a 10-year issue to purchase a slightly shorter maturity issue that offered several basis points more in yield. Overall we are equal weight this sector versus the Index and close to neutral with duration. We would expect any upcoming trades to be maintenance type trades to replace a call or maturity, or perhaps a swap to adjust interest rate risk. We would not anticipate adding any significant new money to this sector given the tightness of spreads versus Treasuries.

Spreads have remained fairly stable within the mortgage sector as well. Lower rates over the part of the summer and until more recent weeks have kept prepayments steady and our activity during this time period has mainly been the reinvestment of prepayments received. We have also taken the opportunity to add new money to the sector with back-ups in yield as well. Earlier in the summer as rates were moving lower we were mainly adding lower coupon 15-year pools so as to add duration but also protect the portfolio from extension risk should rates start to increase. More recently we have swapped out of a couple of lower coupon 30-year pools and into a higher coupon 30-year pools to reduce duration a bit as rates have moved higher the past few weeks. While still underweight versus the index, we have increased our weighting in this sector overall. We will continue to monitor interest rate movements and adjust duration as needed while also looking to add selectively as attractive opportunities arise.

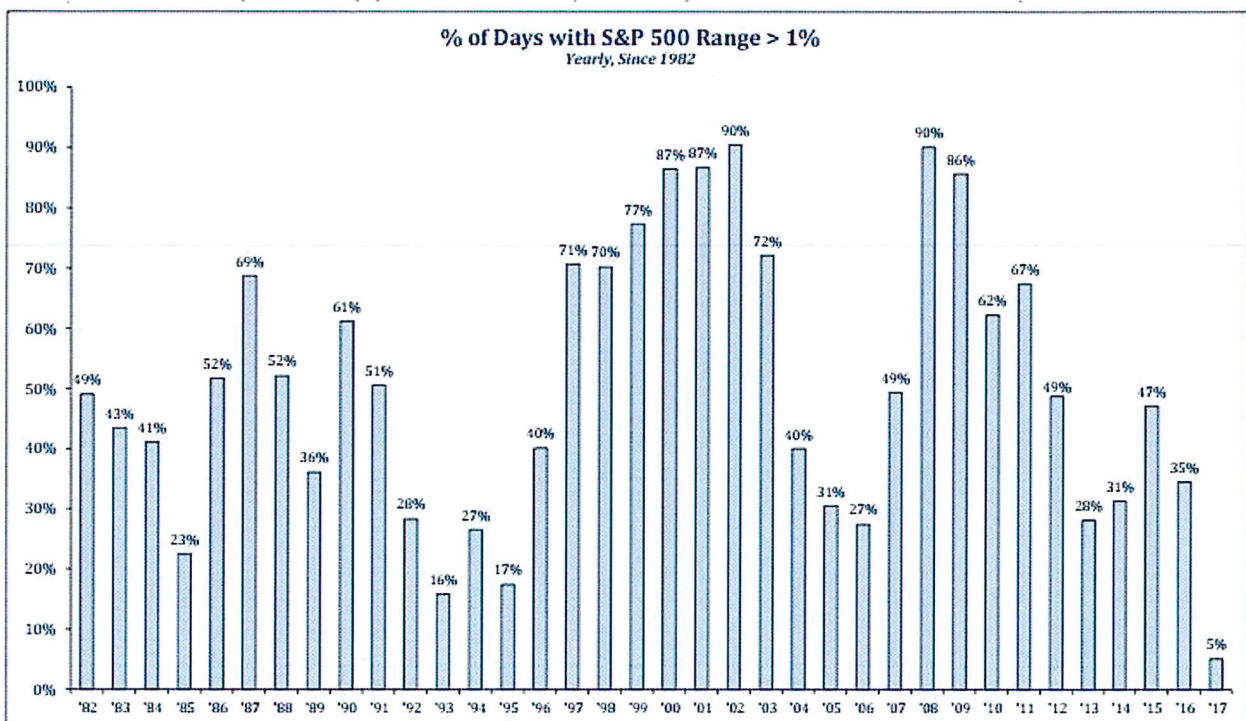
Lastly, we have selectively added money to our Treasury portfolio as well. Earlier in the summer we added late 2021 maturity as rates had sold off a bit and this part of the curve had steepened. Later we added a small block of 10-year notes to raise our weighting a bit and add a small bit of duration as rates had started to decline. More recently we added a blocks of 7.5-year and 5.5-year notes to raise our weighting again, as well as to diversify our exposure on the curve a bit more. We are still underweight the sector as a whole but the duration remains longer than that of the Index. We continue to watch yield levels closely and will adjust our Treasury positions and duration as needed.

Domestic Equity Strategy

By Hunter Bronson

Domestic equity markets continued their strong run with the Dow, Nasdaq, and S&P 500 indices once again setting fresh all-time highs. The S&P 500 was up a little over 4% in the quarter, its 8th straight quarterly advance and was driven by outperformance in the technology, energy, telecom, materials, and financial sectors. Interestingly, each of these sectors would be beneficiaries of higher corporate CAPEX – the next leg of the cycle that we have been anticipating for some time. Over the last four quarters, the S&P 500 total return has been over 14%, and every sector is now in positive territory for the year.

As in recent quarters, volatility remains extremely low. In fact, the S&P 500's average daily change was only 0.3% - the lowest since 1968, and 2017 has seen the fewest number of +/- 1% moves since intra-day data has been recorded.



*Intra-Day data only goes back to 1982.

Figure 1 (Strategas)

All of this seeming complacency despite geopolitical risk from North Korea, domestic political turmoil, and three major, destructive hurricanes. It seems that equity investors are increasingly becoming used to climbing the wall of worry.

While pundits focus on (and probably overplay) the risks to equity markets presented by geopolitics and natural disasters, thoughtful bears do make good points about valuation levels and very high levels of corporate profits. They worry that margins could and should mean-revert over the cycle. This would lead to lower earnings, lower levels of sentiment (valuation multiples) and meaningfully lower prices from these levels. Still others worry that stronger-than-expected inflation will kick off a Fed tightening cycle that will strangle economic growth and end the party abruptly.

We absolutely take these risks seriously and watch vigilantly for them. However, we think it is a little early to play defense. We take on each risk below.

Valuations

We concede that domestic equities are not objectively cheap, but we don't think they are overly expensive, either. The loudest bears point to the Shiller cyclically-adjusted P/E at 30x the average of the last 10 years' of earnings. This is a little higher than the 20-year average of 27x, but we don't think it is obscene for the following reasons:

1. The measure is saddled with a historically painful earnings crisis of 2007/2008 during which earnings fell by over 35% y/y. When this artifact of the recession rolls off in 2018, all things equal, the Shiller P/E will look meaningfully cheaper.
2. Global growth continues to accelerate, driving a meaningful earnings bull. We believe more earnings growth will drive the denominator in multiples higher, making valuations appear more reasonable.

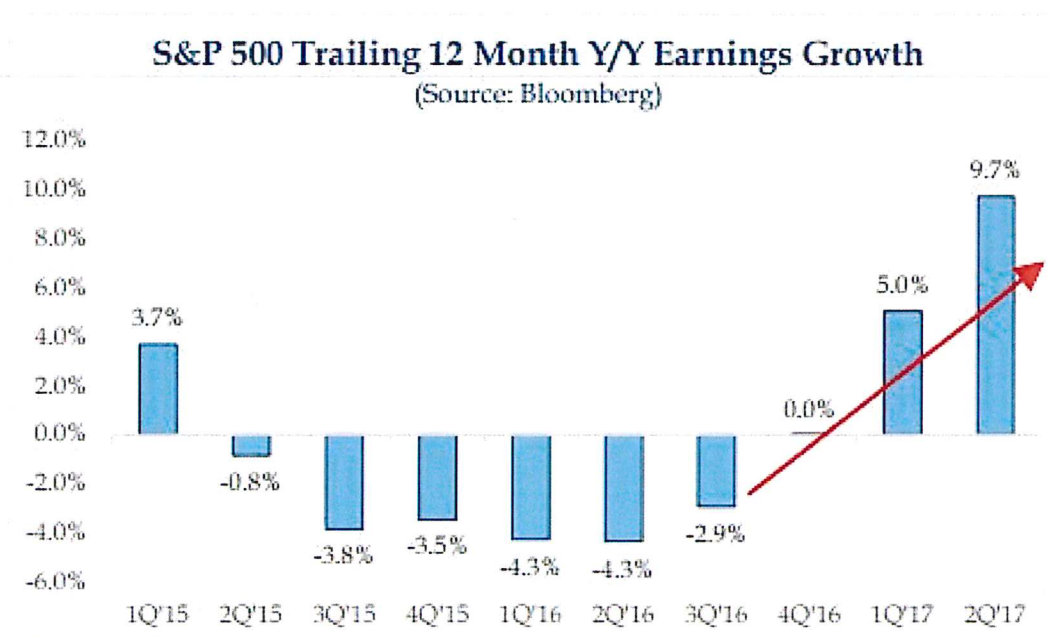


Figure 2 (Strategas)

We also believe that there could be upside optionality around corporate tax reform and repatriation. For the first time since the crisis, we see CEOs indicating that they are seriously considering ramping up their CAPEX spending (Figure 3, below). As we have discussed in the past, CAPEX spending is a necessary condition for productivity growth, which has significantly lagged since the crisis. With CAPEX picking up, unemployment very low, and wages accelerating, we anticipate that productivity will provide a bump to GDP growth and, hence, earnings.

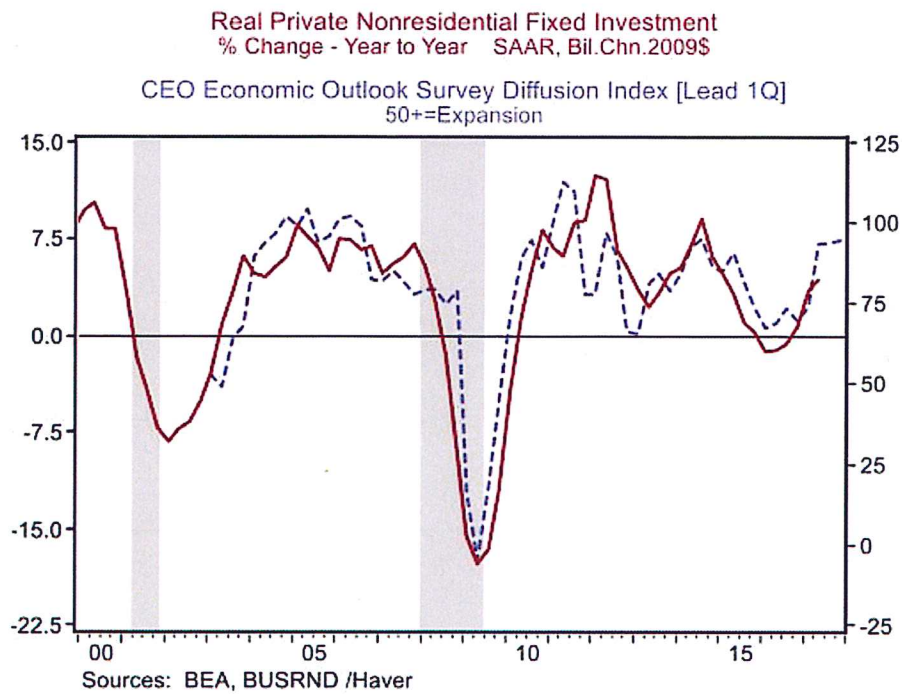


Figure 3: CEO Economic Outlook survey and CAPEX

We have seen estimates that every percentage point decline in the effective corporate tax rate could add \$1.30 to S&P 500 earnings next year. Additionally, if an estimated \$1T in foreign earnings are repatriated, this would boost the earnings yield from 4% to 8%. Any or all of these developments should be bullish for equities, as we think very little upside from legislation is priced into stocks.

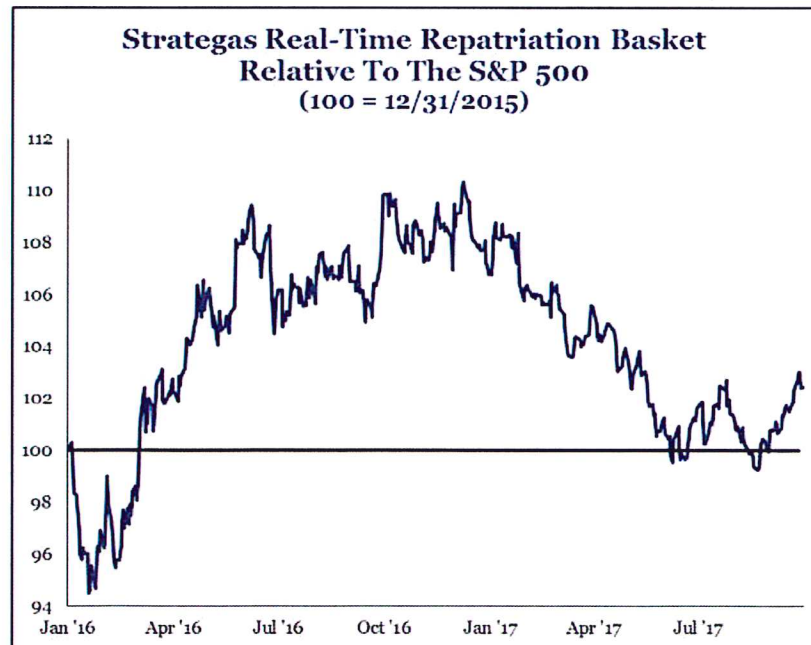


Figure 4: Strategas Repatriation Basket vs. S&P 500

Profit Margins

As you see in Figure 5, below, corporate profit margins continue to hover around all-time highs. Historically, margins have been less sticky and tended to mean-revert. Bears continue to see this reversion as an inevitability when poking holes in the bull thesis.

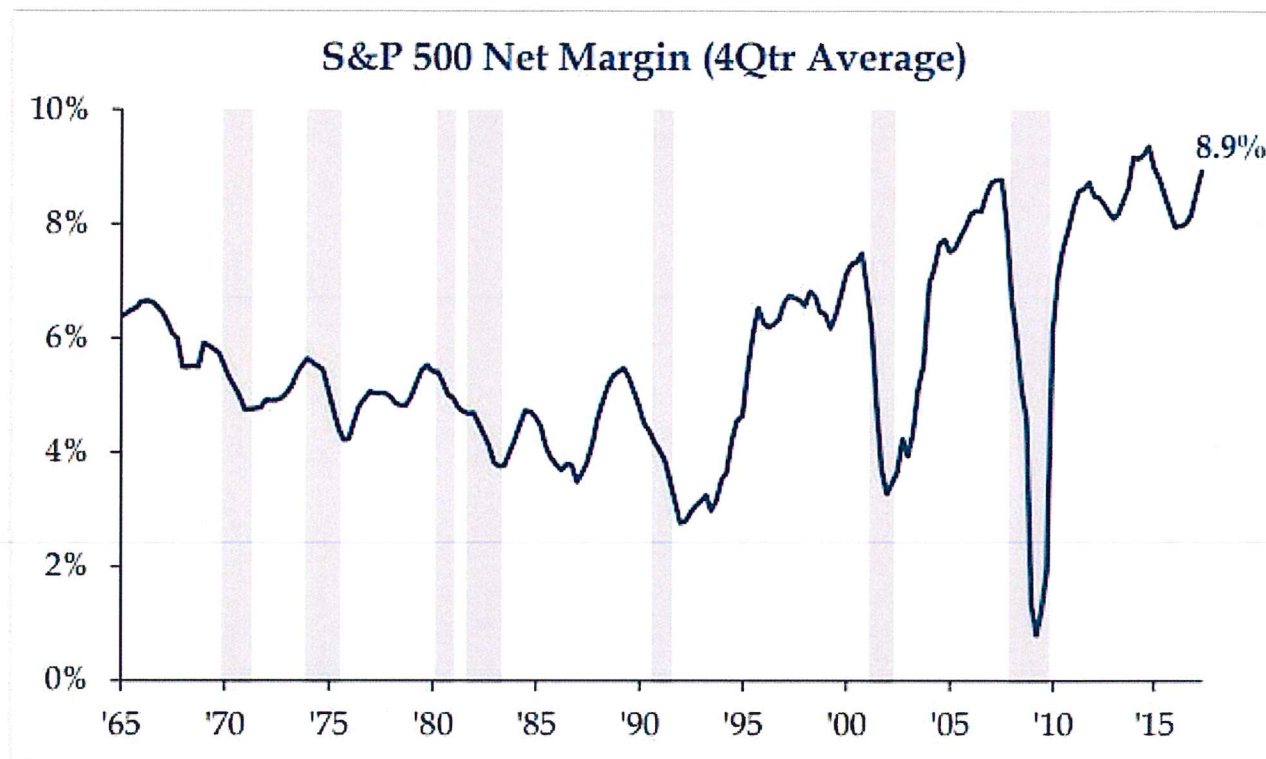


Figure 5 (Strategas)

We have discussed this condition in different sections of this report in the past, but we think it is worth revisiting here. We think that high levels of profitability could be the result of increasing levels of concentrated corporate power. If this is right, then the causes are several, and we believe that they will be hard to reverse:

- Rapidly accelerated globalization since the 1980s has increased operational leverage and encouraged the growth of a handful of massive global brands. These companies have erected giant defenses that are hard to breach.
- Corporate power in the form of voting rights and lobbying intensity have entrenched global powerhouses in the halls of Washington. Lobbying spending in and of itself has become a powerful type of moat.
 - The RSA attempts to capture this phenomenon through our Policy Fund, which has performed very well since inception.
- The rise of winner-take-all and platform economics have resulted in a few truly dominant global near-monopolies (Facebook, Amazon, Netflix, Google).

- Interestingly enough, populists on both sides of the Atlantic are turning their attention to the monopoly power of the FAANGs and may look to rein it in. We are watching these developments closely and appreciate what it may mean for profit margins.

BIG TECH MAKES VAST GAINS AT OUR EXPENSE - FT, 9/17/17

Can the Tech Giants Be Stopped? - WSJ, 7/14/17

GOOGLE DOESN'T WANT WHAT'S BEST FOR US, NYT, 8/12/17

Internet Giants Once Above the Fray, Are on the Defensive in Washington – Reuters, 9/24/17

Inflation

Absent some unforeseeable exogenous shock or policy error, we believe that inflation is the best leading indicator of economic recessions and major equity bear markets, and we pay close attention to it. In the past, average hourly earnings growth nearing 4% has been a great indicator of impending inflationary conditions. Figure 6, below, indicates that we likely have a ways to go.

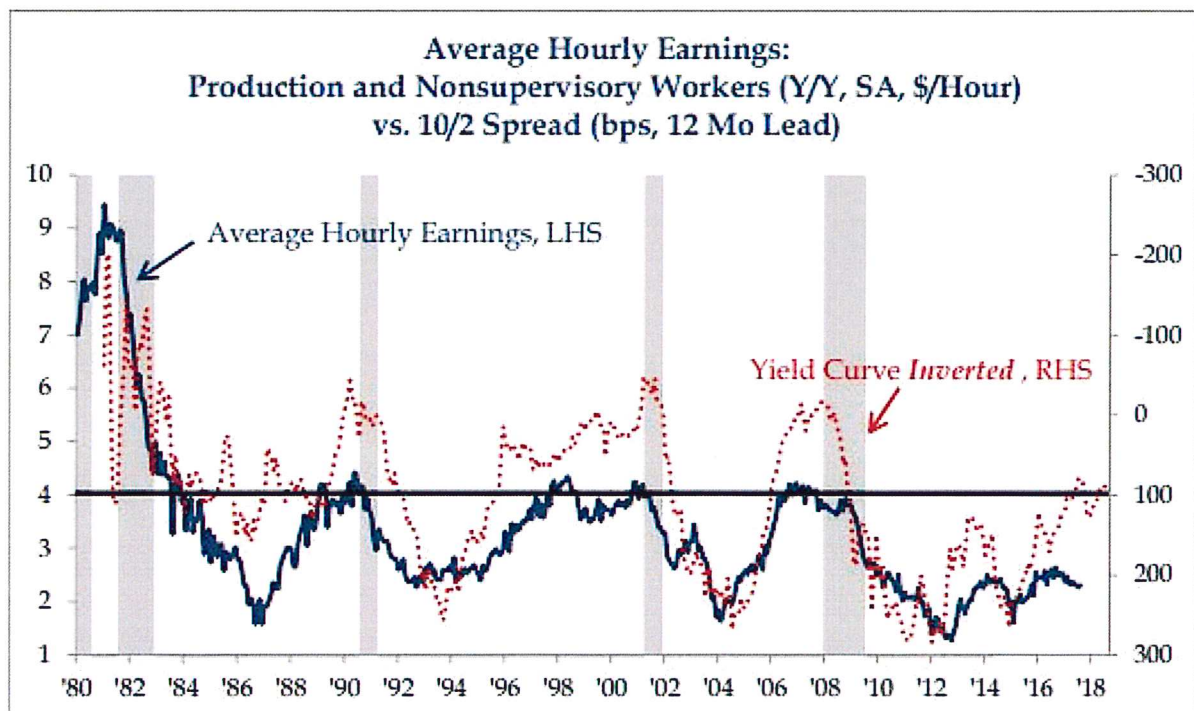


Figure 6 (Strategas)

Other indications of mal-investment and, hence, impeding inflation are heavy equity inflows, acceleration of M&A/IPO activity, rising real rates, and widening credit spreads. We see little evidence of any of these symptoms in the market today.

Source: ICI

Annual Flows

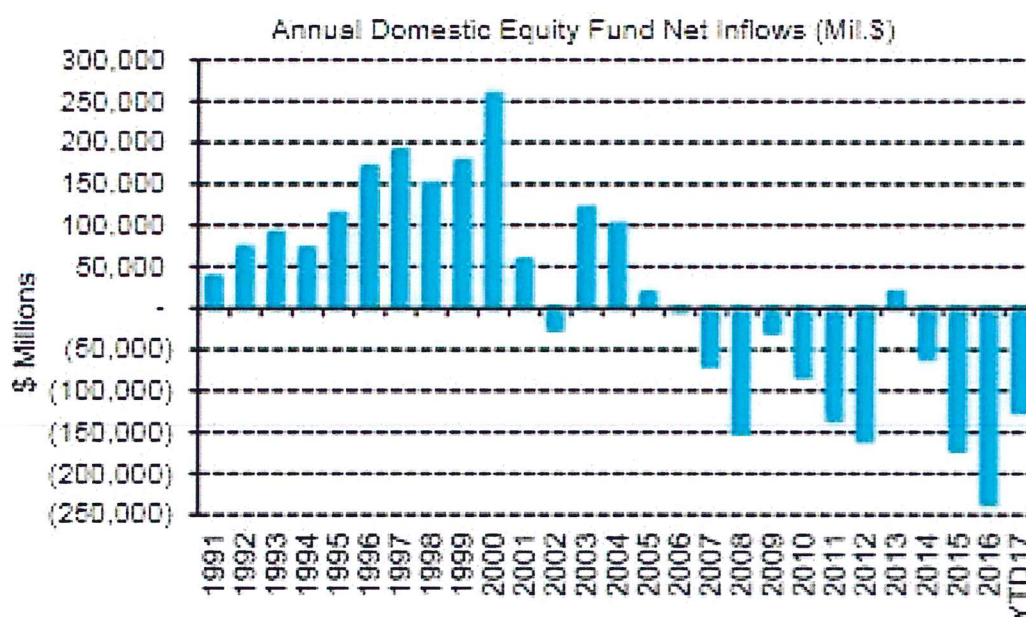


Figure 7: Annual domestic equity flows are still in a deficit condition (Source: Citi)

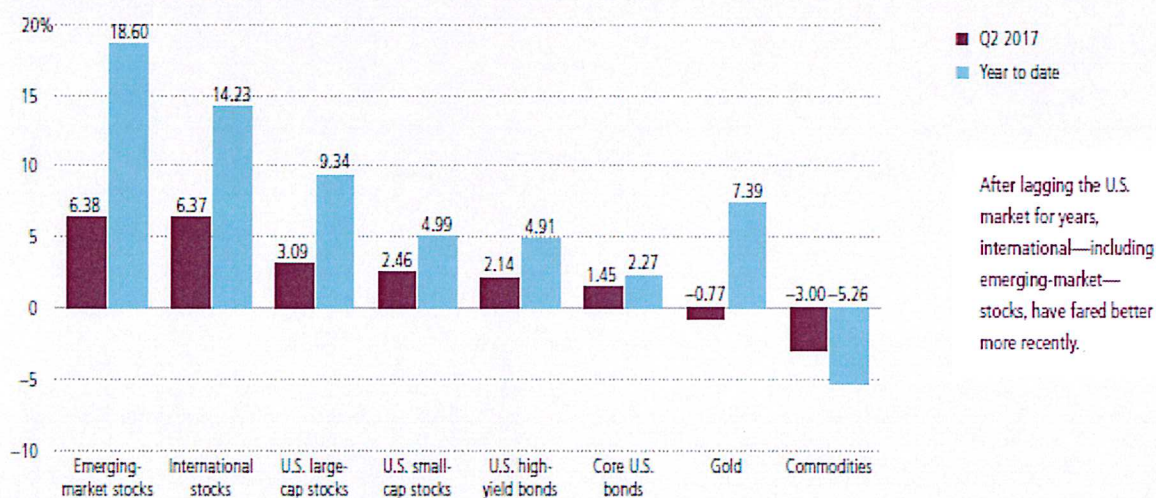
To close, we believe that valuations indicate an equity market priced for moderate returns with significant upside kickers from fiscal policy. Exogenous political and geopolitical risks abound and give market pundits something to worry about, but when do they not? We have our eyes on these issues, but we don't think they present any real risk to markets at the moment. We will be ready to act if they do. We think margins and earnings growth remain sticky, but we are cognizant of what global populism might bring. Finally, we are keeping a close eye on inflation, as we think it presents the biggest risk to global growth and equity markets, but we do not believe it is an imminent threat.

International Equity Strategy

By Steve Lambdin

International equities posted very impressive results in the second quarter of 2017 as volatility remained quite low in the period. Corporate earnings remained stellar, we saw continued monetary support from the central banks, and low inflation pushed investors toward equities in a big way. Investors witnessed very encouraging economic trends in Europe as industrial output and employment gains were impressive. In Japan, growth improved in the key manufacturing and services sectors as well, pushing equity markets higher to fresh 52-week highs. Recent elections in Europe went as expected with no real surprises. Brexit negotiations in the quarter provided no clear direction and remained a gray area for investors. In China, we saw no real surprises in the quarter as growth nearly matched expectations and overall economic conditions presented nothing overly negative. Investors embraced all of this and continued pouring money into international equity mutual funds and ETF's, as these flows into this asset class led almost all other asset classes thus far into 2017. No doubt these positive developments outweighed the recent news on increasing cyberattacks, continuing turmoil in the Middle East, and rapidly escalating tensions with a hostile North Korea. As always, these present some level of risk to the equity markets in varying degrees. Absent any new drastic actions on the geo-political front, we believe most investors remain optimistic that business conditions are strong enough to provide a climate for gains in global equities going forward.

Asset class returns As of June 30, 2017

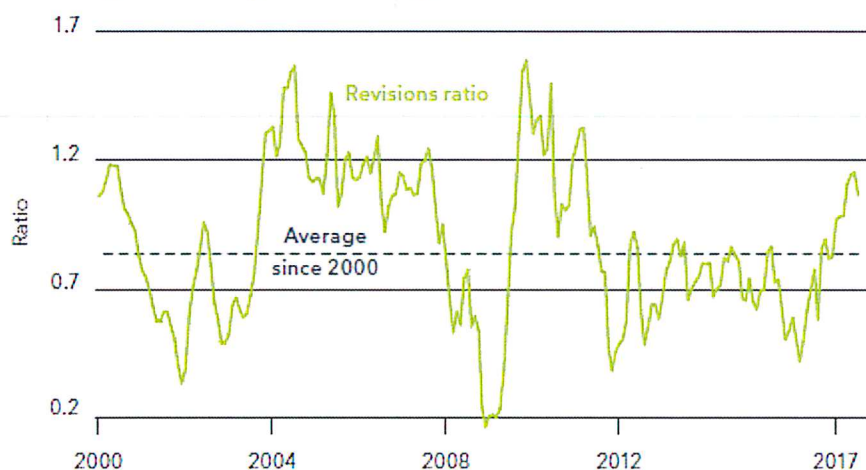


Source: John Hancock Investments; Morningstar Direct

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +6.12% and +6.27% respectively during the second quarter of 2017 vs. +3.09% for the S&P 500 Index. This was the second straight quarter where global stocks outperformed U.S. stocks. The U.S. dollar fell again in the quarter and provide a nice boost for unhedged U.S. investors. The U.S. dollar fell -3.6% vs. the Euro, -3.1% vs. the British Pound, and was nearly flat against the Japanese Yen. In all, currency was a +3.4% benefit to unhedged U.S. investors in the MSCI EAFE Index in the quarter. The European region was significantly stronger than the Pacific region, as the movement of the Euro was a major tailwind to performance. From an economic sector standpoint, nine out of 10 economic sectors posted positive returns for the second quarter in a row as Technology and Utilities led the way. Energy and Materials struggled a bit as oil slipped another -9% in the period as commodities where under a bit of pressure.

Earnings comeback

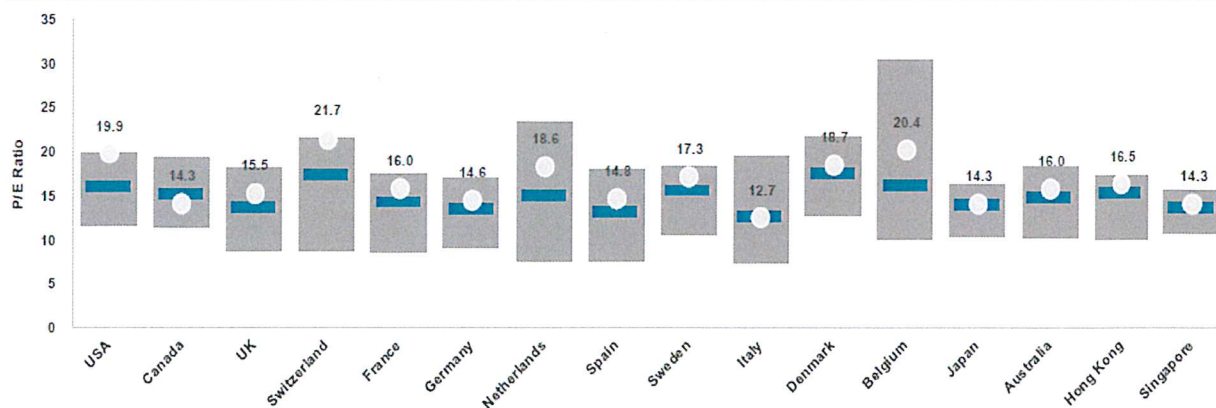
Global equities earnings revisions ratio, 2000-2017



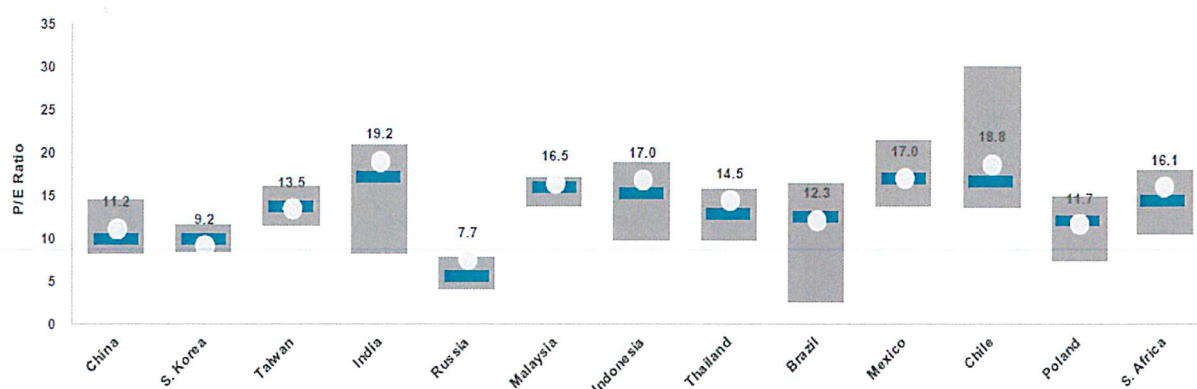
Sources: BlackRock Investment Institute, with data from MSCI and Thomson Reuters, July 2017. Notes: The lines show the number of companies in the MSCI ACWI Index with 12-month forward earnings-per-share (EPS) estimates revised up from the previous month divided by the number of companies with downward EPS estimate revisions.

So far into the third quarter of 2017, global equities continue to be on a tear, especially in the emerging markets. Most major indices look very strong with many near all-time highs. A global bull market remains in place. International equities are benefitting from a robust economic outlook, tame inflation and interest rates, and the continuing fall of the U.S. dollar. It has been a while since we have witnessed a synchronized global recovery, even if it is at a slower pace vs. previous history. This has pushed the MSCI EAFE Index and the MSCI Emerging Markets Index up +5.4% and +7.9% respectively thru the end of September, vs. +4.5% for the S&P 500 Index. Earnings revisions should be moving higher in this environment as we could be seeing even further equity market gains ahead, even as valuations look stretched.

Developed Markets: 7-Year P/E Valuation Ranges



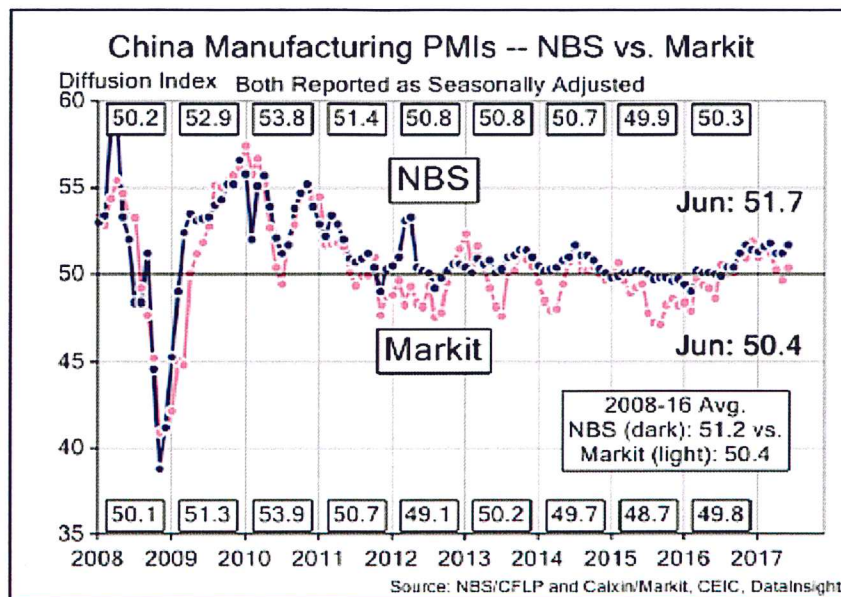
Emerging Markets: 7-Year P/E Valuation Ranges



Source: Baird Market Chartbook; Morningstar Direct; MSCI

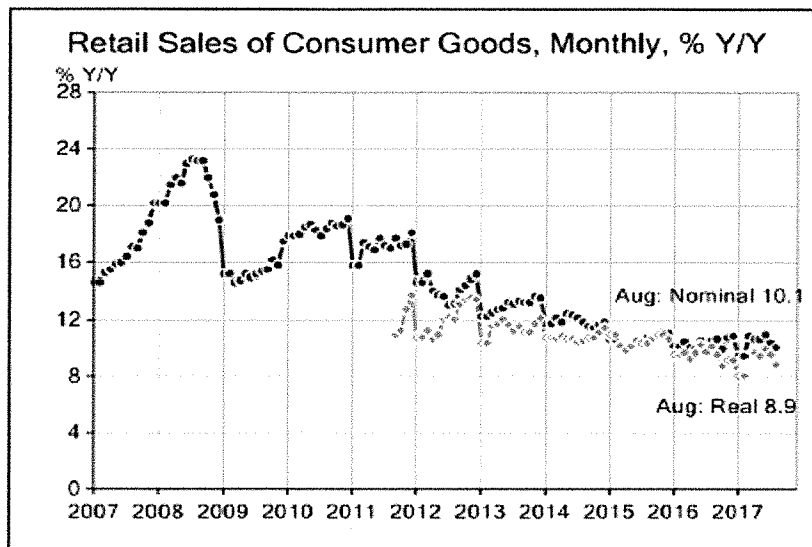
Asia Update

For the second quarter in a row, the Asian equity markets pleased most investors with a positive return. The MSCI Pacific region rose +3.9% in the second quarter as record corporate earnings in Japan and renewed optimism in the labor markets pushed markets higher in this region. The Japanese equity market was the real strength of the region as these equities returned +5.2% in the period. On the other end of the spectrum, the equity markets in Australia were weak and posted a -2.4% return in the period, as falling commodity prices proved too much to overcome. Chinese equities were also very strong in the period, posting a +10.7% return, benefitting from a surge in the technology sector across the Asian basin.



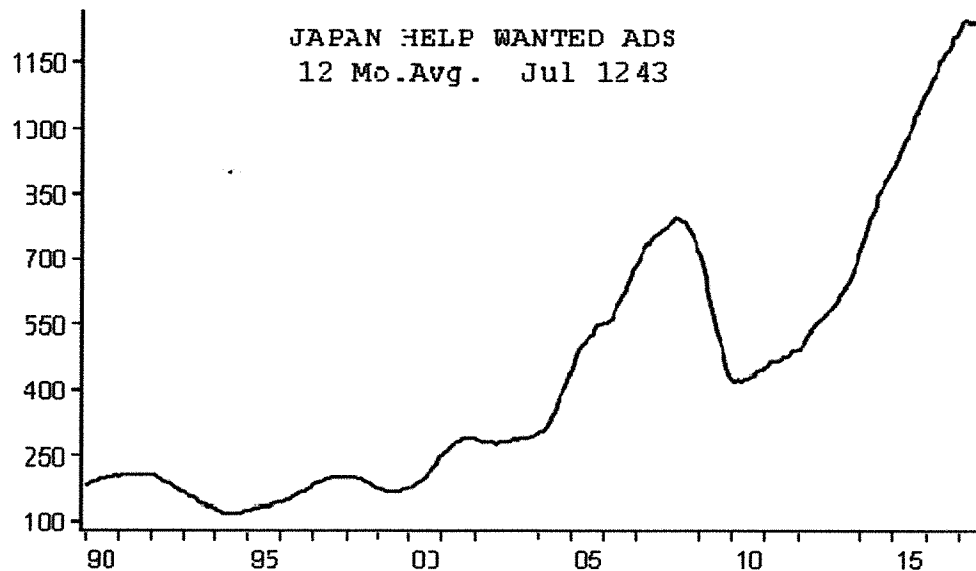
Source: Evercore ISI

China's economy continued to surprise most investors as growth remained stable in the second quarter as GDP rose +6.9% from a year earlier, matching what we saw in the previous quarter. Growth remained resilient even as government officials try to curb the excessive speculative activity in this economy. The ongoing global recovery is fueling robust exports at the moment. This economy appears to be on solid footing at the moment as prospects look good for the balance of the year. We still expect officials here to continue to focus on the buildup of risks and bubbles in the economy. Industrial production remained strong recently, as June rose +7.6% from a year earlier, which was much better than what many economists were expecting. Fixed asset growth climbed +8.6% in the first half of 2017, which was a bit better than forecasts, but just a slight deceleration from the pace in the first quarter of the year. Exports continue to be very strong in 2017 and are reported up +11.3% in USD in June, well above most forecasts. The ongoing strength in the Asian technology sector bodes well for this key metric as we head into the later part of 2017. Retail sales continue to remain strong as July sales rose +10.4%, which puts sales growth at +10.4% for all of 2017. The consumer still looks very strong here and is a major driver of the strength seen in the economy recently. Inflation picked up from earlier in the year as August consumer prices rose +1.8% from the year earlier period. Food prices are up recently from adverse weather conditions in parts of China over the last few months. However, inflation remains well contained here. Looking out into late 2017, we believe the economy remains a bit stronger than we have been anticipating and the government's official target of growth for 2017 should easily be made. No doubt China is a major benefactor of the ongoing pickup in growth being experienced around the globe at the moment. Perhaps this will continue to put an upward bias on the equity markets here.



Source: Evercore ISI

The slow and steady recovery in Japan continued in the second quarter, as GDP grew +.6% from the previous quarter, or +2.5% from the year earlier period. This marks the 6th quarter of growth in a row and the longest period of expansion since 2001. The economic picture looks decent as corporate profits are accelerating and the yen is falling, which bodes well for exports. In fact, the movement of the yen should continue to benefit this economy as we move thru the next couple of quarters. Coming as no surprise, the Bank of Japan (BOJ) remained on hold at its late September meeting with its current policy remaining in place. The BOJ kept its short term rate at -.10% and is still targeting a 10-year government bond target yield at 0%. Having a negative short term rate remains a controversial issue with many puts and takes on the benefits of this in the economy. Industrial production remained good, as August was up +5.4% from a year earlier, consistent with what we have seen over the previous few months. Small business confidence continued its recent trends as July readings came in at 50.0, which is consistent with an economy that is in an expansion. We believe this key statistic needs to keep this critical level if a recovery is to continue. Consumer confidence continued to improve since last quarter, but not at the pace we would like to see, as September's reading of 43.9 matched the highest level of 2017. Core prices in Japan continue to trend higher as August prices rose +.7% a year earlier, which is the most in two years. However, this still leaves inflation at about half of the BOJ's target. The labor market remains tight as the August unemployment remained at 2.8% while the jobs-to-applicant ratio moved to 1.52. These readings should mean we are on the cusp of accelerating wage gains. This is very key if the economic expansion is to gain any momentum, which thus far has been isolated to the export side of the economy.



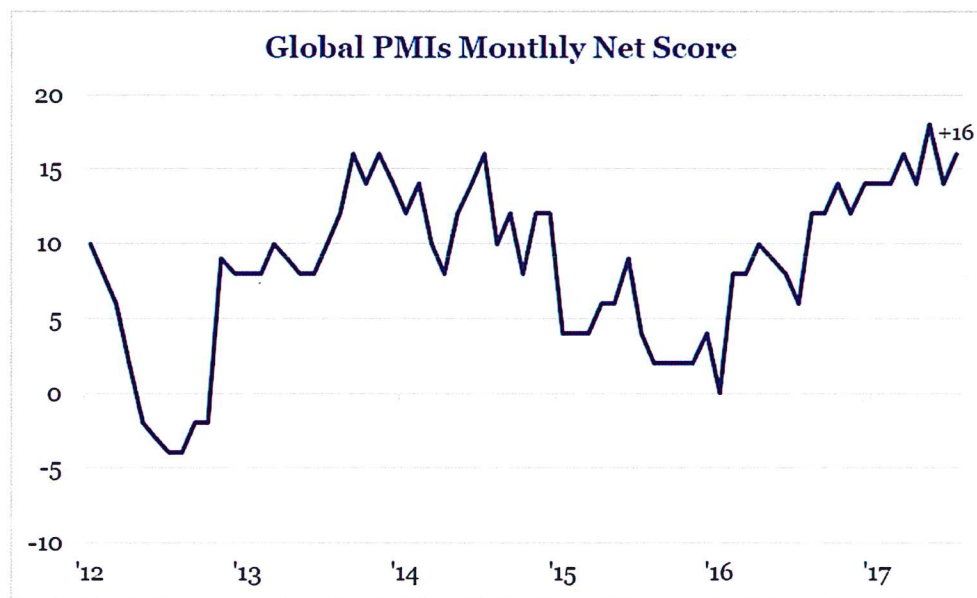
Source: Evercore ISI

Europe Update

European equities posted good gains again as solid economic fundamentals, decreased political uncertainty, and growing corporate earnings all led to an increasing risk appetite amongst investors toward the equity markets in Europe. The defeat of anti-European Union candidates in France and the Netherlands, as well as the re-election of Merkel in Germany, removed a lot of political risk to the region, which allowed the markets to move higher. Virtually all equity markets in Europe moved up in the second quarter, while Austria, Finland, and Denmark led the way. From an economic standpoint, we saw some of the best data points since the great recession, which is a good sign of the recovery going on in this region. Brexit discussions proceeded at a painfully slow pace, as each side wants to proceed with maximum caution. We are beginning to believe that not much will happen until we near a final deadline for new agreements to be in place, which at some point could present an issue for the equity markets here. At its early September meeting, The European Central Bank (ECB) continued to maintain its key interest rate levels as well as its asset purchase targets for this year. In addition, ECB President Mario Draghi continued to posture for an eventual exit from the massive stimulus program. However, the timetable for this seems not to be a near term event as the ECB is well behind the U.S. FED on this front. The MSCI European Index (ex. U.K.) continued to move higher in the second quarter and was up another +8.4%, and again was the best performing region in the EAFE Index. Investors seem to have a growing appetite for European equities.

The European economic expansion continued to accelerate in the second quarter as GDP climbed +.6% from the previous quarter, or +2.3% from the year earlier period. This surprised most investors as many forecasts were below this level.

This economy is clearly gaining momentum at the margin as growth is at the best pace we have witnessed in some time. Private consumption and investment were the main contributors to this growth. Trade also was a contributing factor as exports increased by more than imports. The northern European nations of Finland, Sweden, and the Netherlands displayed growth well ahead of the overall Eurozone level, while the German economy, which is a key economy in the Eurozone, grew by about an average pace. Industrial production continues to grow and was up +2.8% in June and +3.2% in July from the year earlier periods. This was a nice acceleration from what we saw in the first quarter. The index of executive and consumer sentiment continued to trend higher lately and rose to 113 in September, the highest level in nearly 10 years. This is just another data point indicating the strength of the current economic backdrop. Retail sales continue to move in the right direction as July sales were reported up +2.6% from a year earlier, which is at a slightly better pace than a few months ago. Perhaps the consumer is getting involved in the picture here finally. The CPI continued to head south as August Core CPI rose only +1.2% from a year earlier, which is yet again at the slowest pace of 2017 thus far. This still remains well below the ECB's targeted rate. On another bright note, the unemployment rate continued to fall as July unemployment fell to 9.1%, which is the best level we have seen since the great recession. At this juncture, the Eurozone economy continues to gain steam as the near term outlook looks solid and we are optimistic this will be a nice catalyst for equity markets in the region.

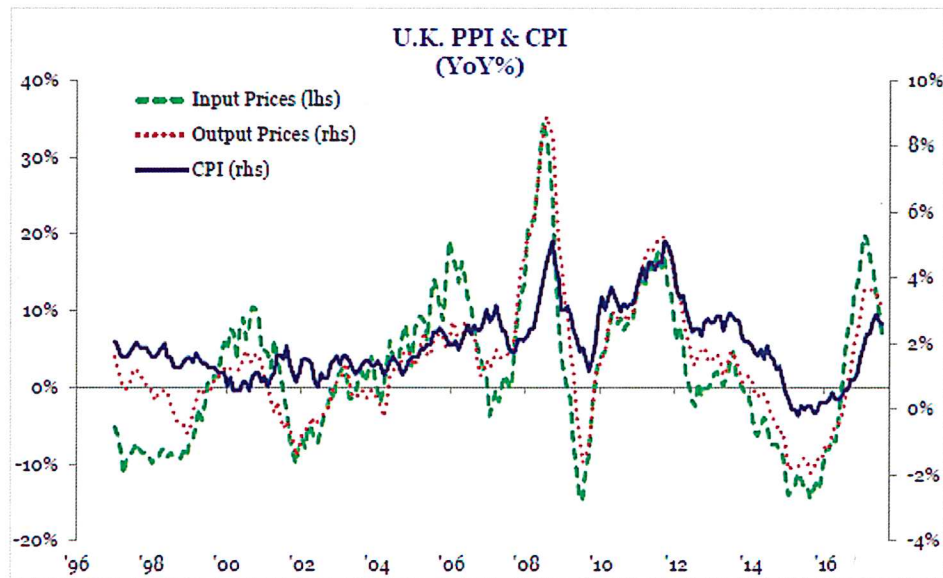


Source: Strategas

When most investors think of what is going on in the U.K., it's hard not to think about the current state of the Brexit discussions. It's been over a year since the referendum and the U.K. government's Brexit position still seems to be cloudy when considering the June election results. It seems to many that Prime Minister

Theresa May's negotiating position has been weakened somewhat. By how much, we do not really know. This probably just complicates matters and could prevent some type of a "soft" Brexit from transpiring. It also makes many wonder if an actual agreement can be reached before the window expires. As more time goes by without an agreement, this will just raise the risk for this economy going forward. No doubt, the world will be watching as this unfolds. The economy seems somewhat stable at the moment, as GDP grew by +.3% in the quarter from the previous quarter, or +1.5% from the year earlier period. Growth was about the same in the second quarter vs. the first quarter. Business investment and net trade contributed to the growth here as the U.K. seems to be benefitting from an overall growing global economy. Industrial production remains decent at the moment, as June and July readings were up modestly from their respective previous months. Manufacturing continues to be an area of strength in overall industrial production. Retail sales rebounded a bit from late spring as August sales were up +2.4% from a year earlier as department store sales were a slight positive surprise. Core CPI continued to move higher recently as August's reading of +2.7% from a year ago is slightly above the Bank of England's (BOE) targeted rate. Clothing and footwear prices have been rising lately as retailers are offering fewer discounts to lure shopper into stores. At its recent September meeting, the Monetary Policy Committee (MPC) opted to maintain its benchmark interest rate at .25% as well as maintaining its bond purchase target of 435 billion pounds, including 10 billion in corporate bonds. This is the same as it has been over the last several meetings. We still believe the MPC remains on track to deliver a rate hike late in 2017. The employment situation remains a mixed bag at the moment, as the July unemployment rate fell to 4.3%, which still remains a 42 year low. Employment rose by 181,000 workers with ending employment at another new record of 32.1 million workers. Wage growth has crept up a bit, as wages grew by +2.1% in the three months to July. However, this still remains a real problem and needs to continue to improve if the economy is to accelerate from here. Investors will be watching the news flow from the MPC regarding interest rate hikes closely over the next few months as well as developments on the Brexit front.

HOT INFLATION APPEARS TO BE COOLING SOME

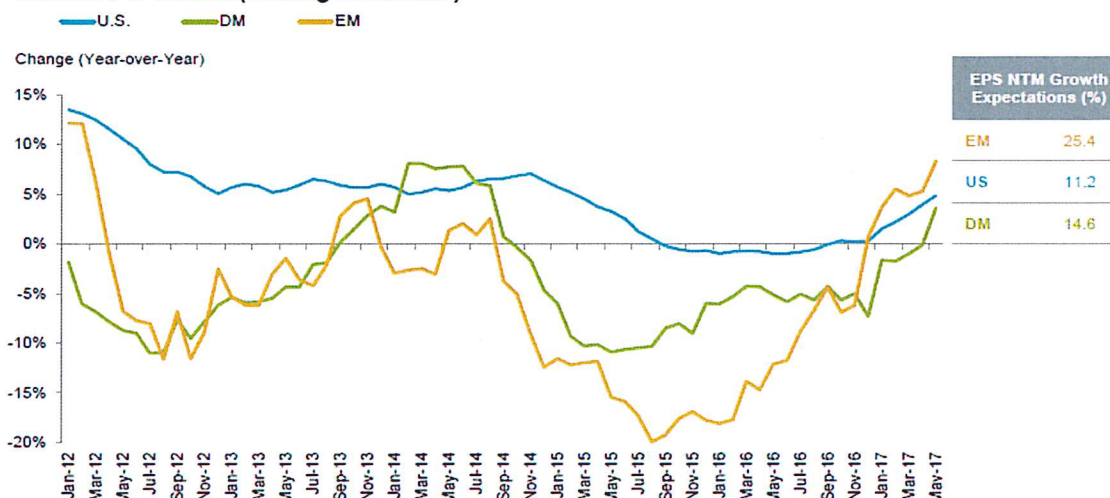


Source: Strategas

Emerging Markets

Emerging market equities continued to move higher as a host of supportive economic data points exceeded most forecasts and a weaker U.S. dollar kept investors hungry for these equities in the quarter. This move was even in front of rhetoric around the potential for a more protectionist U.S. trade policy. We continue to see emerging market equities as a benefactor for equity investors looking to take on more risk. Economic reforms are continuing across many of these markets and will only add to the appeal of these equities as progress is made on this front. China, which is always a wildcard with regard to one's outlook with this asset class, still seems to be meeting its slowly reducing growth forecasts, perhaps bringing a little ease to most investors. For our fiscal year, the MSCI Emerging Markets Index (net) rose +22.4%, which is the best performing equity asset class this fiscal year. This is the first time this has happened in several years. Also, valuations which are not cheap by any historical measure to itself, are still below that of other equity asset classes and give investors one more attractive attribute to hang onto. The combination of lower valuation and accelerating earnings growth is a recipe we like. Risks are always present here, but we still like the prospects going forward into our new fiscal year.

Global EPS Growth (Trailing 12 Months)



Source: Fidelity Investments, MSCI, and Factset

International Equity Activity/Strategy

We continue to have a positive outlook toward the global equity markets. Earnings revisions seem to be picking up even more steam, inflation still remains well contained, interest rates are low enough to spur growth, and several of the central banks still look accommodative to us with little in the way of surprises expected. This is consistent with our previous quarterly outlook as well. While valuations are not cheap in many markets by most measures, we still see further upside in equities provided growth continues. The recent elections in Europe seem to have passed without much drama, removing at least one area of risk for the markets. Other sources of risk remain the uncertainty surrounding the Brexit negotiations, China, U.S. trade policy negotiations, as well as the worsening North Korean situation. Beyond any of these issues changing suddenly for the worse, we see the potential for higher global equity markets from here.

We are looking to add somewhat aggressively to our emerging markets exposure now as well as over the next few months. This is one area we believe has the potential for good gains over the next several years. We have remained very aggressive with our put writing on EEM over the last few months and expect to continue to be going forward in an effort to add to this asset class after an extended period of under-performance lasting several years. Premiums for doing this strategy still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 2.0% of total assets and approximately 11.1% for MSCI EAFE equities, which still remains below peer group averages. *(Credit is given to the following entities for charts provided: Blackrock, MSCI, Thomson Reuters, Baird Market Chartbook, Strategas, Fidelity Investments, Factset, John Hancock Investments, Evercore ISI, and Morningstar Direct)*

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE
RATES OF RETURN
PERIODS ENDING August 31, 2017



RATES OF RETURN - GROSS OF FEE

U.S. EQUITY

	NAV	1 Month	3 Months	CYTD	FYTD	1 Year	3 Years	5 Years	10 Years	Incept. Date
TRS CORE FUND	2,736,009,959	0.24	3.28	11.65	16.15	16.40	9.01	14.18	6.92	Oct-94
TRS S&P 500 FUND	6,309,968,818	0.33	2.87	11.06	15.13	15.43	9.21	14.03	7.53	Oct-94
TRS MID CAP INDEX	1,327,150,847	-1.53	0.97	5.34	13.17	12.46	8.14	14.03	8.96	Oct-94
TRS S&P SMALL CAP INDEX	1,015,496,804	-3.61	0.45	0.56	11.85	12.62	9.42	14.81	9.12	Mar-01
TRS MIDCAP ACTIVE FUND (SSF)	626,786,409	-2.33	0.14	5.48	13.08	11.99	6.19	11.70	7.79	Oct-94
TRS LARGE CAP POLICY FUND	169,033,132	-0.07	4.74	16.20	17.81	18.44				Jan-15
TRS LARGE CAP VALUE FUND	151,285,559	-1.92	0.34	1.84	8.92	12.92				Jul-15
TRS OPTION COLLATERAL	0	0.00	0.00							Sep-03
TRS TOTAL DOMESTIC EQUITY	12,335,731,527	-0.40	2.40	9.23	14.66	14.84	8.85	13.95	7.52	Oct-91
TRS CUSTOM DOMESTIC EQUITY INDEX		-0.23	2.53	9.84	15.35	15.29	9.26	14.32	7.87	Jan-94

S&P 500

S&P MID CAP 400

S&P SMALLCAP 600

		0.31	3.01	11.93	16.21	16.23	9.54	14.34	7.61	Feb-54
		-1.53	0.94	5.28	13.09	12.37	8.07	13.99	8.87	Feb-82
		-2.57	1.32	1.13	12.39	13.11	9.25	14.42	8.62	Feb-84

INTERNATIONAL EQUITY

TRS EMERGING MARKETS FUND

TRS INTERNATIONAL EQUITIES

TRS TOTAL INTERNATIONAL EQUITY

TRS CUSTOM INTERNATIONAL EQUITY INDEX

	486,282,745	2.49	9.73	29.52	22.78	25.91	2.65	5.47		Oct-11
	2,756,998,473	0.06	2.69	17.00	16.27	17.70	3.32	9.00	2.16	Nov-94
	3,243,281,217	0.41	3.69	18.70	17.20	18.84	3.43	8.74	2.25	Nov-94
		0.30	3.62	18.58	17.17	18.62	2.96			Oct-12

MSCI EAFE (NET)

MSCI EMERGING MARKETS

		-0.04	2.66	17.05	16.21	17.64	2.83	8.48	1.62	Jan-70
		2.23	9.41	28.29	22.95	24.53	2.38	5.30	2.43	Jan-81

TRS TOTAL GLOBAL EQUITY

TRS CUSTOM GLOBAL EQUITY INDEX

	15,579,012,744	-0.23	2.67	11.10	15.24	15.70	7.76	12.86	6.31	Oct-75
		-0.12	2.76	11.55	15.76	15.99	7.98	13.02	6.38	Jan-94

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE
RATES OF RETURN
PERIODS ENDING August 31, 2017



RATES OF RETURN - GROSS OF FEE

FIXED INCOME

	NAV	1 Month	3 Months	CYTD	FYTD	1 Year	3 Years	5 Years	10 Years	Incept. Date
TRS DOMESTIC FIXED INCOME	2,484,536,453	0.75	1.24	3.98	1.37	1.32	3.23	2.87	5.20	Aug-99
TRS CUSTOM DOMESTIC FIXED INDEX		0.84	1.37	4.07	1.06	0.96	2.92	2.58	4.86	Jan-90
TRS TOTAL FIXED (ex. Private Placements)	2,484,536,453	0.75	1.24	3.98	1.37	1.32	3.23	2.87	5.20	Oct-03
TRS CUSTOM GLOBAL FIXED INDEX		0.84	1.37	4.07	1.06	0.96	2.92	2.58	4.86	Jan-90
Barclays Aggregate Bond		0.90	1.23	3.64	0.55	0.49	2.64	2.19	4.40	Jan-76
TRS PRIVATE PLACEMENTS	2,366,386,177	0.50	1.54	4.03	5.53	1.60	8.31	11.96	6.03	Oct-03
TRS TOTAL FIXED INCOME	4,850,922,630	0.63	1.39	4.01	3.36	1.44	5.68	7.03	5.42	Oct-93

ALTERNATIVE INVESTMENTS

TRS PREFERRED AND PRIVATE EQUITY	524,052,006	-0.16	-0.44	8.89	8.64	-0.20	2.38	9.27	-9.97	Sep-03
TRS REAL ESTATE	2,319,517,619	-0.29	-0.28	0.02	0.04	7.49	7.71	5.57	3.20	Oct-03
TRS TOTAL ALTERNATIVES	2,843,569,625	-0.27	-0.31	1.50	1.48	6.25	6.44	5.75	0.26	Oct-03
TRS TOTAL F.I. PLUS ALTERNATIVES	7,694,492,255	0.30	0.76	3.07	2.66	3.08	6.00	6.57	3.75	Oct-93

CASH

TRS CASH ACCOUNT	323,836,868	0.09	0.27	0.59	0.75	0.80	0.43	0.31	0.70	Sep-03
TRS SHORT TERM INVESTMENTS	599,717,659	0.12	0.34	0.80	1.01	1.08	0.74	0.58	1.11	Oct-03
TRS TOTAL CASH	923,554,527	0.11	0.32	0.75	0.95	1.01				Oct-14

TOTAL PLAN

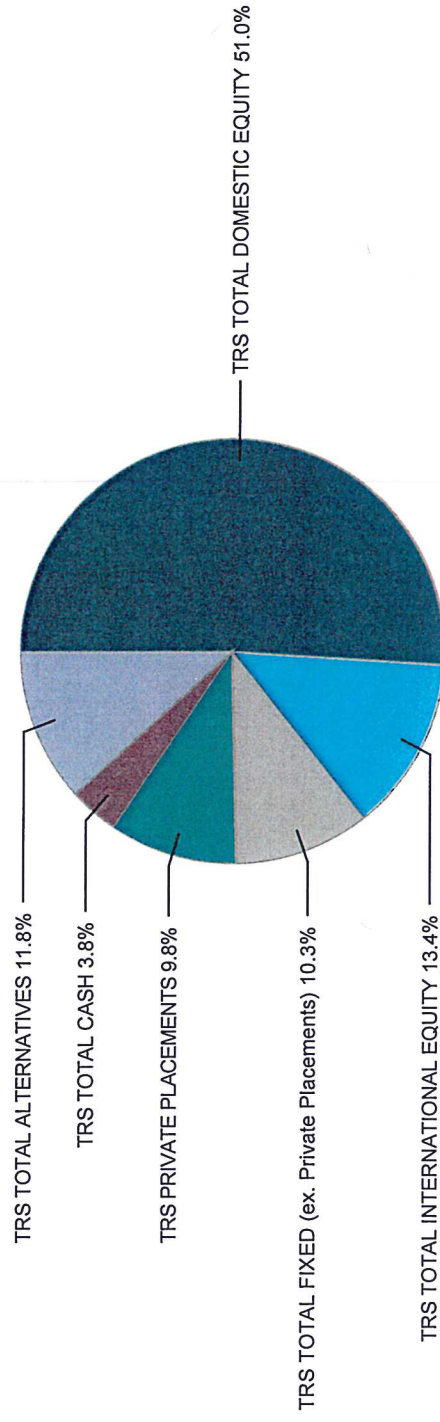
TRS TOTAL PLAN	24,197,059,527	-0.05	1.95	7.98	10.35	10.78	6.89	10.31	5.21	Oct-87
TRS TOTAL PLAN POLICY		0.11	2.13	8.32	10.43	11.08	6.25	9.34	5.42	Oct-03

RETIREMENT SYSTEMS OF ALABAMA

MANAGER ALLOCATION ANALYSIS
PERIOD ENDING August 31, 2017



ALLOCATION BY ASSET CLASS



	NAV	NAV ONE YEAR AGO	ALLOCATION
TRS TOTAL DOMESTIC EQUITY	12,335.7	11,679.4	51.0
TRS TOTAL INTERNATIONAL EQUITY	3,243.3	2,821.4	13.4
TRS TOTAL FIXED (ex. Private Placements)	2,484.5	2,560.0	10.3
TRS PRIVATE PLACEMENTS	2,366.4	2,470.3	9.8
TRS TOTAL CASH	923.6	471.9	3.8
TRS TOTAL ALTERNATIVES	2,843.6	2,671.2	11.8
TRS TOTAL PLAN	24,197.1	22,674.2	100.0

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE
RATES OF RETURN
PERIODS ENDING August 31, 2017



SUMMARY OF PERFORMANCE - GROSS OF FEE

U.S. EQUITY

	NAV	1 Month	3 Months	CYTD	FYTD	1 Year	3 Years	5 Years	10 Years	Incept. Date
ERS CORE FUND	1,477,451,414	0.24	3.26	11.66	16.16	16.41	9.02	14.20	6.96	Oct-94
ERS S&P 500 FUND	3,093,016,121	0.33	2.87	11.09	15.16	15.46	9.18	14.01	7.52	Oct-94
ERS MID CAP INDEX	587,029,276	-1.53	0.96	5.33	13.16	12.45	8.14	14.03	8.97	Oct-94
ERS S&P SMALL CAP INDEX	417,634,457	-3.61	0.45	0.56	11.85	12.62	9.42	14.81	9.12	Mar-01
ERS MIDCAP ACTIVE FUND (SSF)	336,758,543	-2.33	0.12	5.47	13.06	11.97	6.19	11.69	7.81	Oct-94
ERS LARGE CAP POLICY FUND	84,510,877	-0.07	4.74	16.20	17.81	18.44				Jan-15
ERS LARGE CAP VALUE FUND	72,255,896	-1.92	0.34	1.85	8.93	12.93				Jul-15
ERS OPTION COLLATERAL	0	0.00	0.00							Sep-03
ERS TOTAL DOMESTIC EQUITY	6,068,656,584	-0.34	2.45	9.45	14.77	14.93	8.82	13.92	7.49	Oct-93
ERS CUSTOM DOMESTIC EQUITY INDEX		-0.18	2.57	10.04	15.43	15.36	9.27	14.32	7.86	Jan-94

S&P 500

S&P MID CAP 400

S&P SMALLCAP 600

INTERNATIONAL EQUITY

ERS EMERGING MARKETS FUND	232,232,237	2.49	9.73	29.51	22.78	25.90	2.65	5.47		Oct-11
ERS INTERNATIONAL EQUITIES	1,212,389,028	0.06	2.69	17.00	16.27	17.70	3.32	9.00	2.16	Nov-94
ERS TOTAL INTERNATIONAL EQUITY	1,444,621,265	0.44	3.76	18.82	17.27	18.93	3.44	8.71	2.26	Nov-94
ERS CUSTOM INTERNATIONAL EQUITY INDEX		0.32	3.69	18.69	17.24	18.69	2.97			Oct-12

MSCI EAFE (NET)

MSCI EMERGING MARKETS

ERS TOTAL GLOBAL EQUITY

ERS CUSTOM GLOBAL EQUITY INDEX

	7,513,277,849	-0.19	2.70	11.16	15.29	15.72	7.79	12.89	6.35	Oct-93
		-0.09	2.78	11.60	15.81	16.01	8.06	13.09	6.45	Jan-94
		-0.04	2.66	17.05	16.21	17.64	2.83	8.48	1.62	Jan-70
		2.23	9.41	28.29	22.95	24.53	2.38	5.30	2.43	Jan-81

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE
RATES OF RETURN
PERIODS ENDING August 31, 2017



SUMMARY OF PERFORMANCE - GROSS OF FEE

FIXED INCOME

	NAV	1 Month	3 Months	CYTD	FYTD	1 Year	3 Years	5 Years	10 Years	Incept. Date
ERS DOMESTIC FIXED INCOME	1,216,009,307	0.76	1.25	4.02	1.40	1.35	3.24	2.87	5.21	Sep-99
ERS CUSTOM DOMESTIC FIXED INDEX		0.84	1.36	4.07	1.05	0.94	2.91	2.58	4.85	Jan-90
ERS TOTAL FIXED (ex. Private Placements)	1,216,009,307	0.76	1.25	4.02	1.40	1.35	3.24	2.87	5.21	Oct-03
ERS CUSTOM GLOBAL FIXED INDEX		0.84	1.36	4.07	1.05	0.94	2.91	2.58	4.85	Jan-90
Barclays Aggregate Bond		0.90	1.23	3.64	0.55	0.49	2.64	2.19	4.40	Jan-76
ERS PRIVATE PLACEMENTS	1,175,907,984	1.51	1.54	4.03	5.52	1.59	8.31	11.93	5.97	Aug-99
ERS TOTAL FIXED INCOME	2,391,917,291	1.13	1.39	4.03	3.46	1.47	5.79	7.16	5.40	Oct-93

ALTERNATIVE INVESTMENTS

ERS PREFERRED AND PRIVATE EQUITY	322,776,638	-0.13	-0.35	9.14	8.94	0.64	3.09	9.72	-7.08	Sep-03
ERS REAL ESTATE	1,124,182,600	-0.28	-0.27	0.02	0.03	7.29	7.60	5.54	3.16	Oct-03
ERS TOTAL ALTERNATIVES	1,446,959,238	-0.25	-0.28	1.90	1.88	5.94	6.08	5.65	-0.64	Oct-03
ERS TOTAL F.I. PLUS ALTERNATIVES	3,838,876,529	0.61	0.75	3.21	2.86	3.07	5.98	6.58	3.27	Oct-93

CASH

ERS CASH ACCOUNT	134,930,322	0.10	0.28	0.60	0.76	0.81	0.44	0.31	0.70	Sep-03
ERS SHORT TERM INVESTMENTS	311,361,675	0.12	0.35	0.81	1.04	1.11	0.78	0.60	1.12	Oct-03
ERS TOTAL CASH	446,291,997	0.11	0.33	0.76	0.96	1.03				Oct-14

TOTAL PLAN

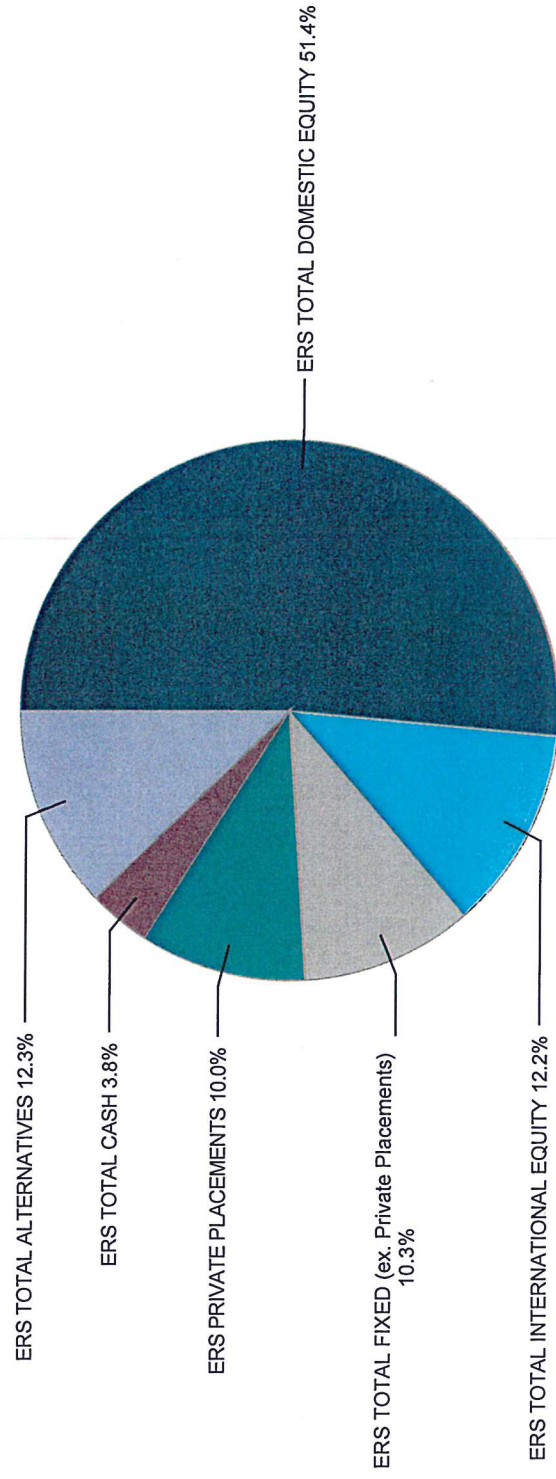
ERS TOTAL PLAN	11,798,446,375	0.08	1.96	8.00	10.36	10.70	6.89	10.20	4.95	Oct-87
ERS TOTAL PLAN POLICY		0.14	2.14	8.30	10.38	11.52	6.95	9.70	5.59	Oct-03

RETIREMENT SYSTEMS OF ALABAMA

MANAGER ALLOCATION ANALYSIS
PERIOD ENDING August 31, 2017



ALLOCATION BY ASSET CLASS



	NAV	NAV ONE YEAR AGO	ALLOC.
ERS TOTAL DOMESTIC EQUITY	6,068.7	5,750.7	51.4
ERS TOTAL INTERNATIONAL EQUITY	1,444.6	1,254.7	12.2
ERS TOTAL FIXED (ex. Private Placements)	1,216.0	1,173.8	10.3
ERS PRIVATE PLACEMENTS	1,175.9	1,227.9	10.0
ERS TOTAL CASH	446.3	307.7	3.8
ERS TOTAL ALTERNATIVES	1,447.0	1,368.1	12.3
ERS TOTAL PLAN	11,798.4	11,082.9	100.0

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE
RATES OF RETURN
PERIODS ENDING August 31, 2017



SUMMARY OF PERFORMANCE - GROSS OF FEE

U.S. EQUITY

	NAV	1 Month	3 Months	CYTD	FYTD	1 Year	3 Years	5 Years	10 Years	Incept. Date
JRF S&P 500 FUND	127,961,879	0.33	2.91	11.29	15.40	15.63	9.32	14.17	7.61	Oct-94
JRF S&P MID CAP INDEX	17,499,223	-1.53	0.96	5.33	13.16	12.45	8.13	14.03	8.93	Oct-94
JRF S&P SMALL CAP INDEX	9,146,239	-3.61	0.45	0.56	11.85	12.61	9.42	14.81	9.12	Mar-01
JRF LARGE CAP POLICY FUND	2,563,506	-0.07	4.74	16.20	17.81	18.44				Jan-15
JRF LARGE CAP VALUE FUND	2,258,308	-1.92	0.34	1.85	8.93	12.93				Jul-15
JRF TOTAL DOMESTIC EQUITY	159,429,155	-0.15	2.54	9.83	14.86	15.07	9.18	14.16	7.79	Oct-93
JRF CUSTOM DOMESTIC EQUITY INDEX		-0.07	2.68	10.46	15.61	15.59	9.36	14.28	7.73	Jan-94

S&P 500

S&P MID CAP 400

S&P SMALLCAP 600

INTERNATIONAL EQUITY

JRF EMERGING MARKETS FUND

JRF INTERNATIONAL EQUITIES

JRF TOTAL INTERNATIONAL EQUITY

JRF CUSTOM INTERNATIONAL EQUITY INDEX

8,085,534	2.47	9.69	29.41	22.65	25.77	2.62	5.46			Oct-11
36,287,609	0.02	2.67	16.94	16.22	17.69	3.32	9.00	2.25		Nov-06
44,373,143	0.46	3.88	19.00	17.34	19.07	3.46	8.72	2.66		Nov-06
	0.37	3.82	18.92	17.38	18.84	3.05				Oct-12

MSCI EAFE (NET)

MSCI EMERGING MARKETS

	-0.04	2.66	17.05	16.21	17.64	2.83	8.48	1.62		Jan-70
	2.23	9.41	28.29	22.95	24.53	2.38	5.30	2.43		Jan-81

JRF TOTAL GLOBAL EQUITY

JRF CUSTOM GLOBAL EQUITY INDEX

203,802,298	-0.02	2.83	11.74	15.44	15.97	7.98	13.02	6.77		Oct-93
	0.03	2.93	12.20	16.03	16.31	8.03	13.01	6.49		Nov-06

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE
RATES OF RETURN
PERIODS ENDING August 31, 2017



SUMMARY OF PERFORMANCE - GROSS OF FEE

FIXED INCOME

JRF DOMESTIC FIXED INCOME

JRF CUSTOM DOMESTIC FIXED INDEX

Barclays Aggregate Bond

JRF PRIVATE PLACEMENTS

JRF TOTAL FIXED INCOME

ALTERNATIVE INVESTMENTS

JRF REAL ESTATE

JRF TOTAL ALTERNATIVES

JRF TOTAL F.I. PLUS ALTERNATIVES

CASH

JRF CASH ACCOUNT

JRF SHORT TERM INVESTMENTS

JRF TOTAL CASH

TOTAL PLAN

JRF TOTAL PLAN

JRF TOTAL PLAN POLICY

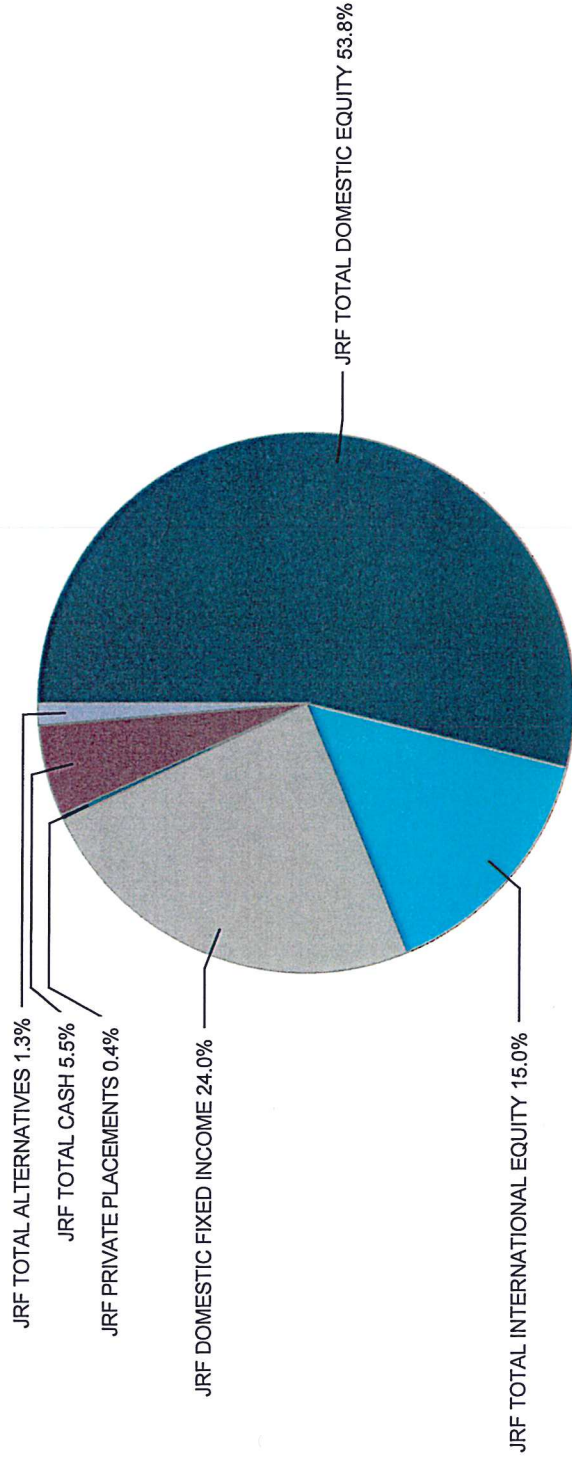
NAV	1 Month	3 Months	CYTD	FYTD	1 Year	3 Years	5 Years	10 Years	Incept. Date
71,069,620	0.74	1.16	3.72	1.02	0.99	3.06	2.79	5.09	Oct-93
	0.86	1.33	3.96	0.86	0.76	2.78	2.49	4.71	Jan-90
	0.90	1.23	3.64	0.55	0.49	2.64	2.19	4.40	Jan-76
1,073,412	0.63	1.97	-9.34	-7.83	-7.42	-0.32	5.16	2.73	Oct-01
72,143,032	0.74	1.17	3.51	0.88	0.86	3.03	2.92	4.60	Oct-93
3,953,773	-0.56	-0.56	-0.00	-0.00	13.27	11.66	8.14	8.13	Oct-03
3,953,773	-0.56	-0.56	-0.00	-0.00	13.27	7.98	5.50	4.35	Oct-03
76,096,805	0.67	1.08	3.32	0.83	1.42	3.42	3.12	4.53	Oct-93
8,648,363	0.10	0.28	0.62	0.77	0.82	0.44	0.31	0.68	Sep-03
7,605,150	0.12	0.35	0.80	1.02	1.09	0.76	0.60	1.15	Oct-03
16,253,514	0.11	0.31	0.71	0.90	0.96				Oct-14
296,152,617	0.17	2.22	8.76	10.40	10.92	6.20	9.75	6.20	Oct-93
	0.23	2.34	9.17	10.76	11.05	6.25	9.85	5.92	Oct-03

RETIREMENT SYSTEMS OF ALABAMA

MANAGER ALLOCATION ANALYSIS
PERIOD ENDING August 31, 2017



ALLOCATION BY ASSET CLASS



	NAV	NAV ONE YEAR AGO	ALLOC.
JRF TOTAL DOMESTIC EQUITY	159.4	146.2	53.8
JRF TOTAL INTERNATIONAL EQUITY	44.4	38.5	15.0
JRF DOMESTIC FIXED INCOME	71.1	74.8	24.0
JRF PRIVATE PLACEMENTS	1.1	1.2	0.4
JRF TOTAL CASH	16.3	14.3	5.5
JRF TOTAL ALTERNATIVES	4.0	3.6	1.3
JRF TOTAL PLAN	296.2	278.6	100.0